

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

## FORM 10-K

(Mark One)

Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 (Fee Required) For the fiscal year ended December 31, 1995 or

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 (No Fee Required) For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission File Number 0-16109

ADVANCED POLYMER SYSTEMS, INC.  
(Exact name of registrant as specified in its charter)

Delaware 94-2875566  
(State or other jurisdiction of (I.R.S. Employer Identification Number)  
incorporation or organization)

3696 Haven Avenue, Redwood City, California 94063  
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (415) 366-2626

Securities registered pursuant to Section 12 (b) of the Act: None

Securities registered pursuant to Section 12 (g) of the Act: Common Stock (\$.01 par value)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (Section 229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

[X]

The aggregate market value of the voting stock of the registrant held by nonaffiliates of the registrant as of February 29, 1996, was \$59,924,243. (1)

As of February 29, 1996, 17,139,292 shares of registrant's Common Stock, \$.01 par value, were outstanding.

Exhibit Index at Page 43  
Total Pages 43

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1 Excludes 6,243,975 shares held by directors, officers and shareholders whose ownership exceeds 5% of the outstanding shares at February 29, 1996. Exclusion of such shares should not be construed as indicating that the holders thereof possess the power, direct or indirect, to direct the management or policies of the registrant, or that such person is controlled by or under common control with the registrant.

DOCUMENTS INCORPORATED BY REFERENCE

DOCUMENT

FORM  
10-K  
PART

Definitive Proxy Statement to be used in connection with the Annual Meeting of Stockholders.

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## ITEM 1. BUSINESS

## INTRODUCTION--FORWARD-LOOKING STATEMENTS

To the extent that this report discusses future financial projections, information or expectations about our products or markets, or otherwise makes statements about future events, such statements are forward-looking and are subject to a number of risks and uncertainties that could cause actual results to differ materially from the statements made. These include, among others, uncertainty associated with timely approval and acceptance of new products, the costs associated with new product introductions, as well as other factors described below under the headings "APS Technology", "Products", "Ethical Dermatology", "License and Technology--Related Agreements", "Government Regulation", "Patents and Trade Secrets" and "Competition". In addition, such risks and uncertainties also include the matters discussed under Management's Discussion and Analysis of Financial Condition and Results of Operations in Item 7 below.

## THE COMPANY

Advanced Polymer Systems, Inc. and subsidiaries ("APS" or the "Company") is using its patented Microsponge(R) delivery systems and related proprietary technologies to enhance the safety, effectiveness and aesthetic quality of topical prescription, over-the-counter ("OTC") and personal care products. The Company is currently manufacturing and marketing in the U.S. nine OTC products based on its technology and is manufacturing and selling Microsponge systems for use by corporate customers in approximately 70 different cosmetic and personal care products sold worldwide. APS holds 81 issued U.S. and foreign patents on its technology and has over 32 other patent applications pending.

The Company, founded in February 1983 as a California corporation under the name AMCO Polymeric, Inc., changed its name to Advanced Polymer Systems, Inc. in 1984 and was reincorporated in Delaware in 1987. On April 2, 1993, the Company acquired Premier Inc., a marketing and distribution company specializing in over-the-counter drug and personal care products. The business combination was accounted for as a pooling of interests.

Products under development or in the marketplace utilize the Company's Microsponge systems in three primary ways: 1) as reservoirs releasing active ingredients over an extended period of time, 2) as receptacles for absorbing undesirable substances, such as excess skin oils, or 3) as closed containers holding ingredients away from the skin for superficial action. The resulting benefits include extended efficacy, reduced skin irritation, cosmetic elegance, formulation flexibility and improved product stability.

In ethical dermatology, New Drug Applications ("NDAs") seeking marketing clearance on two APS-developed ethical dermatology products have been filed with the U.S. Food and Drug Administration ("FDA"). The first filing in September 1994 was for a melanin-based sun protection cream. The second NDA, which was submitted in February 1995, was for a prescription acne preparation licensed to Ortho Pharmaceutical Corporation, a Johnson & Johnson ("J&J") subsidiary.

APS has established several alliances with multinational corporations including J&J and Rhone-Poulenc Rorer to develop products which incorporate Microsponge systems. In general, these alliances provide for the client companies to pay the costs of product development, clinical testing, regulatory approval and commercialization. In return, the clients receive certain marketing rights to the products developed. APS typically receives an initial cash infusion, future payments contingent on the achievement of certain milestones, revenues from the manufacture of Microsponge systems, and royalty payments based on third party product sales. J&J and Rhone-

Poulenc Rorer also have made equity investments in the Company. APS and Dow Corning Corporation formed a joint venture alliance in 1992 to develop and commercialize Polytrap(R) and Microsponge systems for the manufacturers of cosmetics and personal care products. In the first quarter of 1996, APS acquired all rights to the Polytrap technology from Dow Corning in exchange for 200,000 shares of APS Common Stock.

APS-marketed products utilizing the Microsponge technology include six acne products sold in the U.S.: Exact(R) Vanishing Cream, Exact Tinted Cream, Exact Pore Treatment Gel, Exact Adult Acne Cream, Exact Cleansing Wipes and Exact Face Wash. Another APS product, EveryStep(R) shoe and foot powder which is designed to eliminate the causes of foot odor, also is marketed in the U.S. In addition, the Company introduced in 1994 two new formulations of Take-Off make-up/facial cleansers which have been improved with a Microsponge-based moisturizing system.

Corporate customers are marketing products containing the Company's technology on a worldwide basis.

To maintain quality control over manufacturing, APS has committed significant resources to its production processes and polymer systems development programs. The Company's manufacturing facility in Lafayette, Louisiana, is responsible for large-scale production of Microsponge systems and related technologies. All products are manufactured according to Current Good Manufacturing Practices guidelines ("CGMPs") established by the FDA. In addition, APS has process development pilot plants in both its Louisiana and California facilities to handle the production of new technologies. APS also has established relationships with contract manufacturers, which provide second-source production capabilities to handle growing product demand. The Company's objective is to utilize these third parties selectively, so that it can maintain its flexibility and direct the bulk of APS' capital resources to other areas such as product development and marketing.

#### APS TECHNOLOGY

The fundamental appeal of the Company's Microsponge technology stems from the difficulty experienced with conventional formulations in releasing active ingredients over an extended period of time. Cosmetics and skin care preparations are intended to work only on the outer layers of the skin. Yet, the typical active ingredient in conventional products is present in a relatively high concentration and, when applied to the skin, may be rapidly absorbed. The common result is over-medication, followed by a period of under-medication until the next application. Rashes and more serious side effects can occur when the active ingredients rapidly penetrate below the skin's surface. APS' Microsponge technology is designed to allow a prolonged rate of release of the active ingredients, thereby offering potential reduction in the side effects while maintaining the therapeutic efficacy.

**MICROSPONGE SYSTEMS.** The basis of the Company's Microsponge systems are microscopic, polymer-based microspheres that can bind, suspend or entrap a wide variety of substances and then be incorporated into a formulated product, such as a gel, cream, liquid or powder. A single Microsponge is as tiny as a particle of talcum powder, measuring less than one-thousandth of an inch in diameter. Like a true sponge, each microsphere consists of a myriad of interconnecting voids within a non-collapsible structure that can accept a wide variety of substances. The outer surface is typically porous, allowing the controlled flow of substances into and out of the sphere.

Several primary characteristics, or parameters, of the Microsponge can be defined during the production phase to obtain spheres that are tailored to specific product applications and vehicle compatibility. By altering parameters, such as material composition, particle size, pore diameter and volume, as well as the resiliency of the Microsponge, APS is able to optimize the release of entrapped ingredients in response to a number of "triggers."

These triggers can include variations in temperature, friction, the volatility of the entrapped ingredient, the presence of moisture or the passage of time. The technology can also provide an absorbent Microsponge, a Microsponge that can both release ingredients and absorb skin oils, or a Microsponge that confines ingredients, such as melanin, permanently within microspheres. Preselection of the programmable parameters thus results in a truly "custom-made" Microsponge designed to meet the specific requirements of the finished product.

Microsponge systems are made of biologically inert polymers. Extensive safety studies have demonstrated that the polymers are non-irritating, non-mutagenic, non-allergenic, non-toxic and non-biodegradable. As a result, the human body cannot convert them into other substances or break them down. Furthermore, although they are microscopic in size, Microsponge systems are too large to pass through the stratum corneum (skin surface) when incorporated into topical products.

BIOADHESIVE MICROSPONGE SYSTEMS (HYDROSPONGE(TM)). The effectiveness of many topical products could be extended by enabling them to adhere more tightly to their site of application. To satisfy this need, APS is developing hydrogel variations of Microsponge systems. Like other Microsponge systems, Hydrospunges are highly porous and capable of entrapping active ingredients for release over an extended period of time. However, unlike other Microsponge systems, they are hydrophilic (have an affinity for water) and can have electric charges that are either positive or negative. These properties allow entrapped ingredients to adhere readily to the skin and hair until released by certain types of triggers, such as soap. They also provide more control over the delivery of certain entrapped ingredients and can potentially improve the product's aesthetic qualities.

COATED MICROSPONGE SYSTEMS. A membrane-coated Microsponge system offers the potential to hold active ingredients in a protected environment and provide controlled delivery of oral medication to the lower gastrointestinal (GI) tract. The Company's focus is on coatings that will not be removed from the Microsponge until exposure to new types of triggers, such as internal body fluids. This approach would open up entirely new opportunities for APS, including oral drug delivery. Among the possibilities under evaluation are systems for encapsulating unpleasant-tasting drugs until they enter the stomach or allowing targeted drugs to remain inactive until reaching their intended site of action (e.g., the small intestine), where they can then provide continuous, extended release therapy.

SPECIALTY APPLICATIONS. In November 1995, the Company signed an agreement with biosys, Inc. to supply Microsponge-entrapped pheromones to develop long-lasting environmentally safe agricultural pest control products. In late 1994, the Company signed an agreement with The Western Company of North America ("Western") to supply Microsponge systems containing industrial chemicals. Western found that Microsponge-entrapped industrial chemicals can be used inside oil wells to allow more cost-efficient recovery of crude oil. While not a principal focus at Advanced Polymer, a wide range of specialty applications could benefit from the value-added contribution of our polymer technology.

#### PRODUCTS

APS is focusing its efforts primarily on the ethical dermatology, OTC skin care and personal care markets in which Microsponge systems can provide substantial advantages. Certain additional applications for the Company's technology are also under development, as noted below.

## ETHICAL DERMATOLOGY

APS defines "ethical dermatology" products as prescription and non-prescription drugs that are promoted primarily through the medical profession for the prevention and treatment of skin problems or diseases. The Company is developing several ethical dermatology products which will require approval of the FDA before they can be sold in the United States. Although these pharmaceuticals are likely to take longer to reach the marketplace than OTC and personal care products, due to the regulatory approval process, the Company believes that the benefits offered by Microsponge delivery systems will allow valuable product differentiation in this large and potentially profitable market. Results from Phase III human clinical studies on two product candidates reaffirm that this technology offers the potential to reduce the drug side effects, maintain the therapeutic efficacy and potentially increase patient compliance with the treatment regimen. The following ethical dermatology products are under development by APS:

**MELANIN-MICROSPONGE SUNSCREEN.** Concern about the sun's harmful effects and its role in aging and skin cancer has resulted in heightened awareness of preventative measures in the sunscreen market. Recently published scientific data indicate that conventional sunscreens may not provide complete protection against UVA rays and their damaging effects on the immune system, which are thought to be related to malignant melanoma, a potentially fatal cancer of the skin and other organs. This APS-developed sun protectant is designed to provide the highest-available protection against the sun's UVA rays as well as protection from the burning UVB rays.

This unique APS product candidate incorporates the Company's melanin-Microsponge system containing genetically engineered melanin, a natural pigment found in skin. The product is designed to evenly distribute melanin over the skin's surface, and mimic the body's own method of providing full-spectrum protection from the sun's rays. The melanin-Microsponge technology already is incorporated into nine personal care products marketed by Lancaster Group in Europe and APS is developing additional product applications for itself and for other corporations.

The Company filed its NDA in 1994 for marketing clearance. Since it involves an entirely new ethical pharmaceutical ingredient and application, the regulatory review process is lengthier and more complex. The Company is continuing to provide additional information in response to FDA comments with respect to its NDA. If approval by the FDA is received, APS expects the product to be marketed in the United States either by its own sales force or, more likely, through a strategic alliance with an established company in the field. There can be no assurance that FDA approval will be received, or that if received, the Company will be able to successfully market melanin-Microsponge sunscreens.

**TRETINOIN ACNE MEDICATION.** In February 1995, the Company submitted an NDA on the use of Microsponge-entrapped tretinoin for improved acne treatment. This submission to the FDA represented the culmination of an intensive research and clinical development program involving approximately 1,150 patients. Tretinoin has been marketed in the U.S. by Ortho Pharmaceutical, a Johnson & Johnson subsidiary, under the brand name RETIN-A(R) since 1971. It has proven to be a highly effective topical acne medication. However, skin irritation among sensitive individuals can limit patient compliance with the prescribed therapy. The Company believes its patented approach to drug delivery reduces the potentially irritating side effects of tretinoin. Upon FDA approval, Ortho Pharmaceutical will market this product. There can be no assurance that FDA approval will be received, or that if received, that Ortho Pharmaceutical will be able to successfully market this product.

**5-FLUOROURACIL.** Another ethical dermatology product candidate, Microsponge-entrapped 5-Fluorouracil (5-FU), was the subject of an Investigational New Drug ("IND") filing in early 1995. 5-FU is an effective chemotherapeutic agent for treating actinic keratosis, a pre-cancerous, hardened-skin condition caused by excessive exposure to sunlight. However, patient compliance with the treatment regimen is poor, due to significant, adverse side effects. Through a joint agreement with Rhone-Poulenc Rorer, the Company is developing a Microsponge-enhanced topical formulation that potentially offers a less irritating solution for treating actinic keratosis.

**TRETINOIN PHOTODAMAGE TREATMENT.** Initial product development was undertaken in 1994 to develop a Microsponge system product for the treatment of photodamage, which contributes to the premature aging of skin and has been implicated in skin cancer. Funding for this second tretinoin treatment indication is being provided by J&J's Ortho Pharmaceutical

subsidiary.

#### OTC SKIN CARE

EXACT(R) ACNE TREATMENTS. The first of these over-the-counter Microsponge-entrapped benzoyl peroxide products, Exact Vanishing Cream was introduced commercially by APS in the third quarter of 1992. During the third quarter of 1993, APS introduced Exact Tinted Cream, which is an extension of the vanishing cream. The tinted formula is designed to both provide treatment and hide pimples. Exact's patented On Demand(TM) system of drug release is designed to provide a steady, controlled amount of benzoyl peroxide medication to treat acne without irritating, inflaming or overdrying healthy skin. It also absorbs excess skin oils to help prevent acne from returning. As demonstrated in a 175-patient clinical study comparing Exact acne cream to the leading competitive commercial benzoyl peroxide acne product, the controlled release mechanism of Exact offers equivalent medication efficacy with significantly less skin irritation. The product is being sold in the United States as a non-prescription, over-the-counter acne treatment.

During 1995, the Company introduced four line extensions; Exact Face Wash, Exact Adult Acne Cream, Exact Pore Treatment Gel and Exact Cleansing Wipes.

TAKE-OFF(R) MAKE-UP/FACIAL CLEANSERS. This is the second major brand of products using Microsponge systems to provide competitive advantages. Two formulations are now being marketed under a licensing agreement with J&J.

#### PERSONAL CARE

POLYMERIC TRANSPORT(R) SYSTEMS. In January 1996, the Company signed a definitive agreement with Dow Corning Corporation, one of the world's largest suppliers of ingredients used in cosmetics and personal care products, to acquire full rights to Dow Corning's Polytrap(R) technology and full responsibility for the continuing commercialization of Polymeric Transport Systems in exchange for 200,000 shares of APS common stock. APS and Dow Corning previously shared these rights under an agreement signed in 1991 whereby the two companies shared in the proceeds from the manufacture and marketing of products based on both APS Microsponge systems and the Dow Corning Polytrap technologies. As a result, patented microspheres were commercialized as Polymeric Transport Systems to: 1) entrap and deliver various ingredients in personal care products, 2) absorb skin oils to eliminate shine without leaving a white residue, and 3) provide a smooth and silky feel to product formulations. The first Polymeric Transport Systems were introduced to industry customers domestically in February 1992 and globally in June and July 1992. The systems include Microsponge systems with vitamin A, glycerin, a UV absorber, skin oil absorber or mineral oil, as well as Polytrap systems containing a polymer powder, cyclomethicone or mineral oil beads. Customized Polymeric Transport Systems are developed upon request to suit specific customer needs.

Entrapping cosmetic ingredients in APS' proprietary Microsponge delivery systems offers several advantages, including improved physical and chemical stability, greater available concentrations, controlled release of the active ingredients, reduced skin irritation and sensitization, and unique tactile qualities. As a result of the APS-Dow Corning alliance, Microsponge and Polytrap systems are now incorporated into approximately 70 leading personal care products worldwide. In the U.S., 8 of the 10 largest companies in the personal care field are using Microsponge systems in lipsticks, face creams and powders, eyeshadows, moisturizers, cleansers, oil control lotions, deodorant products, or other primarily cosmetic products.

APS' trade-marked Microsponge name does not appear on most of these products, because of the need to protect proprietary positions. Instead, "acrylates copolymer," a general term for various polymer-based technologies, is listed among the product ingredients.

NEET(R). Effective September 1995, the Company acquired exclusive U.S. rights to Neet hair removal products from Reckitt & Colman. Under the licensing agreement, APS is handling the manufacturing, sales, marketing, distribution and product development of Neet products in the United States. Neet is a long-established, multi-million dollar brand of lotions, creams and roll-ons used to remove unwanted hair from the surface of the skin. The licensing agreement also provides for a reciprocal exchange of technology between APS and Reckitt and Colman.

EVERYSTEP(R) FOOT POWDER. In January 1992, APS introduced EveryStep, a unique shoe and foot deodorant with five active ingredients entrapped in Microsponge systems. This product is a daily use, continuous-action, odor-fighting powder.

BABY FRESH(R) WITH ULTRA GUARD(R) BABY WIPES. Scott Paper Company, one of APS' early licensees, has incorporated an APS Microsponge system into a baby wipe to both cleanse a baby's sensitive skin and help protect against common diaper rash. Moisture is a major contributor to diaper rash, a painful skin irritation. Ultra Guard is Scott's trademark for the APS delivery system. Baby Fresh with Ultra Guard skin protectant is designed to provide effective skin protection without blocking air from the skin by the controlled release of water-repellent dimethicone, a substance commonly used in baby creams, lotions and skin protectants. This product was launched in the U.S. during 1992, and marketing efforts were expanded in 1993 to include Canada and the United Kingdom. In addition to the normal supply agreement, APS receives royalty income on worldwide product sales.

MELANOSPONGE(R) TOILETRIES, COSMETICS AND SUNCARE PRODUCTS. Melanosponge, APS' trademark for the Microsponge system entrapping genetically engineered melanin, has been added to a number of premium cosmetic products marketed by Lancaster, a major European cosmetics manufacturer, in major European markets. These include an eye cosmetic, a lipstick and a moisturizer commercialized in early 1992, as well as six additional cosmetic products that offer protection from the sun's damage.

#### OTHER PRODUCT APPLICATIONS

While not the principal focus of APS development efforts, other products could benefit from the value-added application of the Company's polymer technology. To date, the Company has chosen to apply its technology to the following non-skin-care fields:

ANALYTICAL STANDARDS. APS initially developed microsphere precursors to the Microsponge for use as a testing standard for gauging the purity of municipal drinking water. Marketed by APS nationwide, these microspheres are suspended in pure water to form an accurate, stable, reproducible turbidity standard for the calibration of turbidimeters used to test water purity.

APS believes its Analytical Standards technology has much broader applications than testing the turbidity of water. The Company has begun to develop hematology standards for industrial use as process monitors in blood plasma manufacturing and as control materials for blood analysis. The Company is also expanding its line of visual haze standards for use in the beer industry and is investigating applications for the paper, semiconductor and pharmaceutical industries which require the use of ultrapure water.

INDUSTRIAL ENZYMES FOR USE IN OIL WELLS. The Western Company of North America, which was acquired by BJ Services Company in 1995, has found that Microsponge- entrapped industrial chemicals can be used inside oil wells to allow more cost-efficient recovery of crude oil. This innovative industrial application of our technology has enabled us to enter a potentially significant new field of supply.

**BIOPESTICIDES.** biosys, a company which develops and commercializes bioinsecticides, conducted extensive studies which showed that the use of the Microsponge technology with biopesticides could provide long-lasting, environmentally safe pest control. biosys will use Microsponge systems to entrap and gradually release non-toxic chemicals called pheromones, which are normally produced by insects to communicate with one another. Microsponge-entrapped pheromones mimic insect communication signals so effectively that targeted insects are unable to distinguish the location of potential mates in sprayed areas for extended periods of time. Although unharmed, the insects are prevented from producing offspring that feed on agricultural crops.

#### MANUFACTURING

**POLYMER RAW MATERIAL.** Raw materials for the Company's polymers are petroleum-based monomers which are widely available at low cost. The monomers have not been subject to unavailability or significant price fluctuations. Raw material costs generally account for less than a third of the total cost of the Company's products.

**PROCESS ENGINEERING AND DEVELOPMENT.** The Company employs chemical engineers and operates two pilot-plant facilities for developing production processes. APS has created process technologies which it believes offer the greatest potential for application to the widest variety of APS products. The equipment used for manufacturing and process development is commercially available in industrial sizes and is installed in the Company's production facility in Lafayette, Louisiana.

**GENETICALLY ENGINEERED MELANIN.** Genetically engineered melanin for the Melanosponge system is provided by Biosource Technologies Inc. ("Biosource") pursuant to license and supply agreements. Under the terms of these agreements, APS has worldwide rights to use and sell genetically engineered melanin in Microsponge systems for all sun protectant, cosmetic, ethical dermatology and OTC skin care purposes. Biosource is guaranteed minimum purchases, receives royalties on product sales and has received certain other financial considerations.

**MICROSPONGE PRODUCTION.** APS has committed significant resources to the production process and polymer systems development required to commercialize its products. The Company has to date manufactured most Microsponge systems in company-owned and operated facilities.

The Company's manufacturing facility in Lafayette, Louisiana, is responsible for large-scale production of Microsponge systems and related technologies. APS also has established relationships with contract manufacturers which provide second-source production capabilities. The Company's objective is to utilize these third parties selectively, so that it can maintain its flexibility and direct the bulk of APS' capital resources to other areas, such as product development and marketing. All products are manufactured according to CGMP. In addition, APS has process development pilot plants in both its Louisiana and California facilities to handle the production of new technologies.

#### MARKETING

The Company's strategy is to retain marketing or co-promotion rights for most of its products in the United States and Canada. Outside of North America, APS initially intends to rely on other companies as partners for marketing, co-promotion, distribution and/or sales of its products. To date, aside from Premier, most marketing activities involve the sale of Microsponge systems directly to corporate customers for whom the Company has performed product research and development activities.

APS' own products are being commercialized through its wholly owned subsidiary Premier, Inc., a marketing and distribution company specializing in OTC drug and personal care products. Premier was acquired by APS in April 1993 in a stock for stock merger for approximately 450,000 shares of APS Common Stock.

Premier provides APS with its own experienced sales, marketing and distribution team. The APS-Premier relationship dates back to 1990, when the two companies incorporated a consumer products company to develop and sell personal care products. Premier subsequently served as an independent marketer for APS, launching and building a presence for the Exact and EveryStep products on a nationwide basis. Premier's capabilities range from launching new products and securing national distribution channels, to increasing the retail presence of established

brands.

Premier, in addition to being the sales and marketing arm of APS, has marketing, licensing and distribution agreements with Johnson & Johnson. The Company's goal is to build a strong market position for APS' topical dermatology and personal care products by providing several products in key market segments. A number of products including new formulations that incorporate Microsponge delivery systems are currently marketed by Premier.

Premier also introduced a Microsponge-enhanced version of Take-Off(R) make-up remover cloths which it markets under a licensing agreement with J&J. This product is used to remove facial and eye make-up.

Until the first quarter of 1996, Dow Corning marketed Microsponge and Polytrap systems to manufacturers of personal care products as part of the Polymeric Transport Systems alliance with APS. The alliance with Dow Corning has allowed APS to expand the use of its technology in the personal care supply field without requiring the Company to expand its own sales and marketing infrastructure. In the first quarter of 1996, APS acquired all rights to the Polytrap technology from Dow Corning in exchange for 200,000 shares of APS Common Stock. Sales and marketing in the U.S. became the responsibility of APS. Dow Corning will continue to serve as the international distributor for these products.

#### LICENSE AND TECHNOLOGY-RELATED AGREEMENTS

Part of APS' business strategy is to ally the Company with major strategic partners. The Company has therefore negotiated several agreements for the development of Microsponge delivery systems, the supply of entrapped ingredients, and the marketing of formulated products. To create an incentive for APS to develop products as quickly as possible, these development and license agreements provide, in some cases, for substantial payments by the client companies during the period of product development and test marketing. Additionally, some agreements provide for non-refundable payments on the achievement of certain key milestones, royalties on sales of formulated products, and minimum annual payments to maintain exclusivity. APS has, in some product areas, retained co-marketing rights.

In general, APS grants limited marketing exclusivity in defined markets to client companies, while retaining the right to manufacture the Microsponge delivery systems it develops for these clients. However, after development is completed and a client commercializes a formulated product utilizing the Company's delivery systems, APS can exert only limited influence over the manner and extent of the client's marketing efforts. APS' client companies may cancel their agreements without penalty.

The Company's material agreements and relationships are set forth below:

JOHNSON & JOHNSON, INC. In May 1992, APS and Ortho Pharmaceutical Corporation, a subsidiary of J&J, entered into a licensing agreement related to tretinoin-based products incorporating APS' Microsponge technology. As part of the agreement, in 1992, license fees of \$6,000,000 were paid to APS. In addition, Johnson & Johnson Development Corporation ("JJDC") purchased 723,006 shares of newly issued APS common stock (amounting to approximately 5% of the Company's then outstanding shares) for \$8,000,000. The license fee provides Ortho with exclusive distribution or license rights for all Ortho tretinoin products utilizing the APS Microsponge system. Ortho's exclusivity will continue as long as certain annual minimum payments are made. In addition, Ortho will pay license fees and milestone payments over time to APS. Milestone, license and equity payments to APS have the potential to total \$24,000,000 of which approximately \$16,250,000 had been received through December 1995. Because the milestones are separate for each product candidate, failure of one product to win FDA approval will not interfere with the potential flow of payments from the other product. APS will receive royalty payments on

net product sales worldwide.

During 1991, \$1,000,000 was received from J&J's Consumer Products, Inc. subsidiary for the rights to purchase selected APS products in the fourth or sixth years after introduction for a predetermined multiple of sales. The first of these products are EveryStep foot powder and the Exact acne treatment and cleanser. Other potential products include a topical feminine hygiene product, a deodorant, and hair and scalp treatment products. J&J may also launch line extensions of its own products incorporating Microsponge delivery systems upon payment of certain development fees and royalties to APS.

In 1994, J&J purchased additional shares of newly issued common stock through its subsidiary JJDC for \$5,000,000. JJDC also received 200,000 warrants exercisable for two years at \$12.00 per share. The number of shares issuable to JJDC was increased to a total of 1,432,101 pursuant to an agreed upon formula tied to the trading price of APS stock prior to January 1996.

RHONE-POULENC RORER. In March 1992, APS and Rhone-Poulenc Rorer ("RPR") restructured their 1989 joint venture agreement to give APS more freedom in developing products. Under the new terms, APS has regained from RPR worldwide marketing rights to products in the prescription dermatology field, including the melanin-based sunscreen product in which RPR had invested approximately \$4,000,000 in development costs. APS also gained ownership of a partially-completed manufacturing facility in Vacaville, California, which the Company sold in December 1995. Also under the new terms, RPR invested \$2,000,000 in cash in APS and relieved APS of the obligation to repay a \$1,500,000 advance. In return, RPR received 705,041 shares of APS stock (approximately 5% of the Company's then outstanding shares) and maintains a minority share in the potential net profits of the melanin-based sunscreen product. Furthermore, RPR has agreed to continue funding the exploration and development of certain dermatology applications of APS' technology in which APS shares marketing rights. Product applications include a 5-FU treatment for pre-cancerous actinic keratosis. In 1995, the Company filed an IND application to begin human clinical testing of 5-FU. As APS maintains co-marketing rights to these products, the companies will pay each other reciprocal royalties on product sales.

DOW CORNING. In July 1991, APS and Dow Corning Corporation formed a collaborative alliance to manufacture and sell both APS' Microsponge and Dow Corning's Polytrap technologies worldwide in the cosmetics and toiletries field. Under the agreement, Dow Corning provided financial assistance in this venture, as well as worldwide sales and support services; APS contributed its technology, research and development, technical support and manufacturing capability for both the Microsponge and Polytrap products. As part of its alliance with the Company, Dow Corning advanced to APS \$1,000,000 which was repaid out of the gross profits of the alliance. In the first quarter of 1996, APS acquired full rights to the Polytrap(R) technology and full responsibility for the continuing commercialization of Polymeric Transport Systems in exchange for 200,000 shares of common stock.

SCOTT PAPER COMPANY. In the first quarter of 1992, after having been one of APS' original licensees in 1987, Scott Paper Company began the regional U.S. launch of Baby Fresh with Ultra Guard baby wipes. Ultra Guard is Scott's trademark for an APS Microsponge system that contains dimethicone to help protect a baby's skin from diaper rash. In early 1993, Scott achieved national distribution for Baby Fresh with Ultra Guard. In the fourth quarter of 1995, Kimberly-Clark announced its intention to acquire Scott Paper Company. This transaction was completed in the first quarter of 1996. One of the conditions of the acquisition imposed by the Federal Trade Commission was that Kimberly-Clark divest the baby wipe business due to the size of the combined business. No buyer for this business has yet been identified.

SMITHKLINE BEECHAM. APS' signed a marketing and distribution agreement with SmithKline Beecham ("SKB") for OraFix denture adhesive, a long-established, multi-million dollar brand in the third quarter of 1993. The SKB agreement provided for Premier to handle product sales, marketing and distribution in return for a management fee. In December 1995, SKB sold the OraFix business to Hogil Pharmaceutical, Inc., and the agreement with Premier terminated.

BJ SERVICES COMPANY. In late 1994, the Company signed an agreement with the Western Company of North America to supply Microsponge systems containing industrial chemicals. Western has found that Microsponge-entrapped industrial chemicals can be used inside oil wells to allow more cost-efficient recovery of crude oil. Western was subsequently acquired by BJ Services Company.

#### GOVERNMENT REGULATION

##### ETHICAL DERMATOLOGY PRODUCTS

In order to clinically test, produce and sell products for human therapeutic use, mandatory procedures and safety evaluations established by the FDA and comparable agencies in foreign countries must be followed. The procedure for seeking and obtaining the required governmental clearances for a new therapeutic product includes pre-clinical animal testing to determine safety and efficacy, followed by human clinical testing, and can take many years and require substantial expenditures. In the case of third-party agreements, APS expects that the corporate client will fund the testing and the approval process with guidance from APS. The Company intends to seek the necessary regulatory approvals for its proprietary dermatology products as they are being developed. NDAs on two APS-developed ethical dermatology products have been filed with the FDA, in September 1994 and February 1995. There can be no assurance that any such marketing clearances will be granted by the FDA on a timely basis, if at all, or that approved products will be economically feasible to commercialize. The FDA also may require post-marketing testing and surveillance programs to monitor the effects of the Company's products. Following initial marketing, product approvals may be withdrawn for noncompliance with regulatory standards or the occurrence of unforeseen problems.

APS' facilities, where the Company manufactures pharmaceutical raw materials, are subject to periodic governmental inspections. If violations of applicable regulations are noted during these inspections, significant problems may arise affecting the continued marketing of any products manufactured by the Company.

While APS does not currently manufacture commercially available pharmaceuticals, its Lafayette, Louisiana plant continues to operate according to CGMP prescribed by the FDA, in anticipation of marketing clearance of ethical dermatology product candidates. This compliance has entailed modifying certain manufacturing equipment, as well as implementing certain record keeping and other practices and procedures which are required of all pharmaceutical manufacturers. The Company believes it is in compliance with federal and state laws regarding occupational safety, laboratory practices, environmental protection and hazardous substance control.

## PERSONAL CARE PRODUCTS

Under current regulations, the market introduction of non-medicated cosmetics, toiletries and skin care products does not require prior formal registration or approval by the FDA or regulatory agencies in foreign countries, although this situation could change in the future. The cosmetics industry has established self-regulating procedures and most companies perform their own toxicity and consumer tests.

## PATENTS AND TRADE SECRETS

As part of the Company's strategy to protect its current products and to provide a foundation for future products, APS has filed a number of United States patent applications on inventions relating to specific products, product groups, and processing technology. The Company also has filed foreign patent applications on its polymer technology with the European Economic Community, Japan, Australia, South Africa, Canada, Korea and Taiwan. The Company received U.S. patent protection for its basic Microsponge system concept in 1987 and now has a total of 18 issued U.S. patents and an additional 63 issued foreign patents. The Company has over 32 pending patent applications worldwide.

Although the Company believes the bases for these patents and patent applications are sound, they are untested, and there is no assurance that they will not be successfully challenged. There can be no assurance that any patent already issued will be of commercial value, or that any patent applications will result in issued patents of commercial value, or that APS' technology will not be held to infringe on patents held by others.

APS relies on unpatented trade secrets and know-how to protect certain aspects of its production technologies. APS' employees, consultants, advisors and corporate clients have entered into confidentiality agreements with the Company. These agreements, however, may not necessarily provide meaningful protection for the Company's trade secrets or proprietary know-how in the event of unauthorized use or disclosure. In addition, others may obtain access to, or independently develop, these trade secrets or know-how.

## COMPETITION

Numerous companies, including major chemical and pharmaceutical companies in the United States, seek to develop products based on enhanced delivery technologies. The established companies have financial and technical resources and production and marketing capabilities substantially greater than those of APS. In addition, most have significantly greater experience in undertaking product and market tests, clinically testing therapeutic products and obtaining approval of the regulatory authorities. The Company expects competition to intensify as technological developments are made and become more widely accepted.

Microsponge systems compete with two time-release drug delivery technologies: liposomes for the delivery of therapeutic agents and the enmeshing of therapeutic agents in a polymer polycarbophil. Existing alternatives to APS' Microsponge delivery systems also include other topical polymeric systems and encapsulation techniques. The competitive polymeric system most closely related to the Microsponge is Dow Corning's Polytrap technology which was acquired by APS in January 1996.

Liposome technologies, which utilize phospholipids, cholesterol or other lipid-based microscopic spheres for encapsulation, release their entrapped ingredients only through a diffusion or vehicle degradation process. This approach has the disadvantage of low payload. Liposomes can be significantly more expensive than Microsponge systems because their manufacturing requires ultrapure raw materials while Microsponge systems are produced from widely available monomers. Liposomes also require strong preservatives to maintain their microbiological

stability, while the APS technology requires no preservatives and is self-sterilizing. Liposomes are primarily directed toward systemic drug delivery.

Microencapsulation differs significantly from the Company's delivery system because once a capsule is ruptured or melted, all of the entrapped substance is released. Furthermore, encapsulation does not offer the same control over programmability or release of the active ingredients offered by Microsponge systems.

#### HUMAN RESOURCES

As of February 29, 1996, the Company had 90 full-time employees, 5 of whom hold PhDs. There were 17 employees engaged in research and development, 38 in pilot manufacturing and production activities, and 35 working in sales, finance, marketing, human resources and administration.

The Company considers its relations with employees to be satisfactory. None of the Company's employees is covered by a collective bargaining agreement.

#### ITEM 2. PROPERTIES

The Company currently occupies 23,040 square feet of laboratory, office and warehouse space in Redwood City, California and 4,800 square feet of office space in Greenwich, Connecticut. Rent expense for these facilities in 1995 were \$246,194 and \$107,444, respectively.

The Company occupies a production facility and warehouse in Lafayette, Louisiana, with a current annual capacity, depending upon the application, to produce 500,000 to 750,000 pounds of entrapped materials. The existing plant, with contiguous acreage, has been designed to allow significant expansion. In 1995, the Company sold this facility and warehouse along with other certain assets and subsequently leased them back for a certain fixed monthly rent over a period of forty-eight months. The Company reported this transaction as a financing transaction since the requirements for consummation of a sale were not met.

The construction of the facility in 1986 was financed primarily by 15-year tax-exempt industrial development bonds. In 1990, the bonds were refinanced. The maturity date of the bonds occurs in installments beginning June 30, 1993, and ending December 31, 2000. The bonds bear a fixed interest rate of 10%. In 1995, the Company extinguished the bonds through an "insubstance defeasance" transaction by placing U.S. government securities in an irrevocable trust to fund all future interest and principal payments.

In March, 1992, as part of the restructuring of the arrangements with Rhone-Poulenc Rorer, APS acquired a partially-completed manufacturing facility in Vacaville, California. APS management decided not to complete the plant, and the facility was sold in December 1995.

The Company's existing research and development and administrative facilities are not being used at full capacity and, as such, management believes that such facilities are adequate and suitable for its current and anticipated needs. Additional manufacturing capacity could be required as APS expands commercial production. It is anticipated that any additional production facilities would be built on land the Company presently occupies in Lafayette, Louisiana.

ITEM 3. LEGAL PROCEEDINGS

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

## PART II

## ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED SHAREHOLDER MATTERS

Shares of the Company's Common Stock trade on the Nasdaq National Market under the symbol APOS. As of February 29, 1996, there were 653 holders of record of the Company's Common Stock.

The company has never paid cash dividends and does not anticipate paying cash dividends in the foreseeable future. The following table sets forth for the fiscal periods indicated, the range of high and low closing sales prices for the Company's Common Stock on the NASDAQ National Market System.

1995	High	Low	1994	High	Low
First Quarter	6	4	First Quarter	7 3/4	5 1/8
Second Quarter	5 7/8	4 1/16	Second Quarter	7	4 3/4
Third Quarter	8 3/8	5 1/8	Third Quarter	6 1/8	3 5/8
Fourth Quarter	7 1/2	4 7/8	Fourth Quarter	5 7/8	4 1/8

Item 6. SELECTED FINANCIAL DATA  
(in thousands, except per share data)

Years Ended December 31,	1995	1994	1993	1992	1991
STATEMENTS OF OPERATIONS					
Total revenues	\$ 16,108	\$ 15,884	\$ 19,932	\$ 15,527	\$ 4,602
Research and development, net	4,139	6,334	7,343	3,726	2,211
Selling, marketing and advertising	6,560	5,669	6,237	4,013	1,394
General and administrative	3,082	2,844	2,988	3,468	2,141
Loss on purchase commitment, including related inventory	600	685	950	--	--
Net loss	(9,359)	(9,759)	(9,877)	(5,545)	(4,312)
Loss per common share	\$ (0.57)	\$ (0.65)	\$ (0.73)	\$ (0.43)	\$ (0.42)
Weighted average common shares outstanding	16,459	15,018	13,527	12,805	10,198

December 31,	1995	1994	1993	1992	1991
BALANCE SHEETS					
Working capital	\$ 4,976	\$ 5,641	\$ 4,555	\$ 14,428	\$ 2,103
Total assets	23,082	23,508	24,378	31,115	14,849
Long-term debt, excluding current portion	6,355	979	3,355	3,672	4,000
Shareholders' equity	5,233	11,786	10,501	20,143	3,061

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

(Dollar amounts are rounded to nearest \$1,000)

To the extent that this report discusses financial projections, information or expectations about our products or markets, or otherwise makes statements about future events, such statements are forward-looking and are subject to a number of risks and uncertainties that could cause actual results to differ materially from the statements made. These include, among others, uncertainty associated with timely approval and acceptance of new products, the costs associated with new product introductions, establishment of new corporate alliances, progress in research and development programs and other risks listed from time to time in the Company's Securities and Exchange Commission filings.

The Company's revenues are derived principally from product sales, license fees and royalties. The Company is currently marketing in the United States nine over-the-counter ("OTC") products based on its patented technology and is manufacturing and selling Microsponge(R) delivery systems for use by customers in approximately 70 different cosmetic and personal care products. Under strategic alliance arrangements entered into with certain multinational corporations, APS generally receives an initial cash infusion, future milestone payments, royalties based on third party product sales and revenues from the supply of Microsponge systems.

The consolidated financial statements for each of the periods presented include the financial results of Premier, Inc. ("Premier"), a marketing and distribution company specializing in OTC drug and personal care products, which was acquired on April 2, 1993. The business combination was accounted for as a pooling of interests, and the historical financial statements of Advanced Polymer Systems, Inc., ("APS" or the "Company") have been restated to include the accounts and results of operations of Premier.

Premier has exclusive arrangements to market and distribute two sunscreen product lines which do not incorporate the Company's technology, Sundown(R) and Johnson's Baby Sunblock(R), on behalf of Johnson & Johnson's Consumer Products, Inc. and has further licensed Take-Off(R) makeup remover from Johnson & Johnson. In addition, effective September 1995, the Company licensed from Reckitt & Coleman the exclusive U.S. rights to the Neet(R) line of depilatory products. The sales of the two sunscreen products and the depilatory product line are highly seasonal and heavily weighted to the first two calendar quarters of each year as retailers buy product for the summer season. Additionally, shipments of Microsponge systems can fluctuate significantly from period to period since manufacturing plans of, and inventory quantities held by, customers are beyond the Company's control.

No major capital expenditures are planned in the coming year, since the Company's manufacturing facilities are complete. Future marketing expenses for the melanin-Microsponge sun protectant product candidate have not yet been determined, as the Company is currently exploring various plans for marketing this product assuming regulatory approval is received, including discussions with prospective corporate partners. If the Company should bear all of the marketing costs for the introduction of this product, the anticipated achievement of profitable operations could be delayed beyond 1997.

Past results are not deemed to be indicative of the future. Assuming FDA approval of its two NDAs, the Company anticipates revenues from sales of these products in future years.

The following tables summarize highlights from the statements of operations expressed as a percentage change from the prior year and as a percentage of product revenues.

STATEMENTS OF OPERATIONS HIGHLIGHTS	Year Ended December 31, 1995	1994	1993	Annual % Change 95/94	% Change 94/93
Product revenues	\$15,203,000	\$14,787,000	\$16,781,000	3%	-12%
Licensing revenues	905,000	1,097,000	3,151,000	-18%	-65%
Total revenues	16,108,000	15,884,000	19,932,000	1%	-20%
Cost of sales	11,047,000	10,149,000	12,840,000	9%	-21%
Research and development, net	4,139,000	6,334,000	7,343,000	-35%	-14%
Selling and marketing	4,756,000	4,012,000	4,284,000	19%	-6%
Advertising and promotion	1,805,000	1,657,000	1,953,000	9%	-15%
General and administrative	3,082,000	2,844,000	2,988,000	8%	-5%
Loss on purchase commitments, including related inventory	600,000	685,000	950,000	-12%	-28%

STATEMENTS OF OPERATIONS HIGHLIGHTS	1995	1994	1993
Expenses expressed as a percentage of product revenues:			
Cost of sales	73%	69%	77%
Research and development, net	27%	43%	44%
Selling and marketing	31%	27%	26%
Advertising and promotion	12%	11%	12%
General and administrative	20%	19%	18%
Loss on purchase commitments, including related inventory	4%	5%	6%

#### RESULTS OF OPERATIONS FOR THE YEARS ENDED DECEMBER 31, 1995 AND 1994

Total revenues for 1995 amounted to \$16,108,000 compared to \$15,884,000 in the prior year, an increase of \$224,000 or 1%. This consisted of product sales of \$15,203,000, an increase of \$416,000 or 3% over the prior year, and licensing revenues of \$905,000, a decrease of \$192,000 or 18% from the prior year.

Revenues from products which incorporate the Microsponge technology totalled \$10,458,000, an increase of \$3,787,000 or 57% over the prior year.

The increase in product revenues over 1994 resulted from increased shipments of Microsponge systems to a variety of personal care and specialty customers, primarily manufacturers of cosmetics and toiletries through the alliance with Dow Corning Corporation.

This increase was offset by a slight decrease in sales of consumer products. While sales of the Exact(R) acne line increased by 71% over the prior year and the addition of the line of Neet(R) products under a licensing agreement with Reckitt & Colman also contributed to sales of consumer products, this was offset by an anticipated decrease in sales of in-licensed sun care products, which do not incorporate the Company's technology. The Company anticipates decreases in sales of sun care products to continue as it focuses greater effort on products which contain the Company's Microsponge system.

The decrease in licensing fees was due mainly to the fact that the prior year included \$894,000 of

revenues recognized under the percentage-of-completion method on now-completed clinical trials, offset by a milestone payment of \$1,500,000 paid to the Company by Johnson & Johnson upon the filing of the New Drug Application for Microsponge-enhanced tretinoin acne cream in February 1995, of which \$750,000 was recognized as revenues.

The gross profit on product revenues for the year decreased to 27% from 31% due to a higher percentage of close-out sales of suncare products, partially offset by improved gross profit on the supply of Microsponge systems.

Research and development expense decreased significantly from \$6,334,000 to \$4,139,000, or by 35%, due to the fact that the prior year included significant external expenses associated with clinical trials for NDAs which have now been filed.

Selling and marketing expense increased by \$744,000 or 19% to \$4,756,000 due mainly to the Company's investment in the initiation of its ethical pharmaceutical marketing effort. Advertising and promotion expense increased by \$148,000 or 9% to \$1,805,000 largely due to a sampling program related to the Company's consumer products, the benefits of which should be realized in 1996, partially offset by reduced spending on print media.

General and administrative expense increased by \$238,000 or 8% to \$3,082,000 due mainly to increased spending on a variety of outside services.

The loss on purchase commitment primarily relates to a contractual commitment for the purchase of melanin in excess of current estimated requirements. Melanin is the key ingredient in the manufacture of the APS-developed UVA/UVB sun protection cream for which an NDA was filed in the third quarter of 1994.

Interest income decreased by \$38,000 or 11% to \$318,000 due mainly to lower average cash balances. Interest expense increased by \$167,000 or 60% to \$446,000 due to the debt financing arranged by the Company in the third quarter.

The net loss for the year of \$9,359,000 was lower by \$400,000 or 4% than the prior year, with reduced research and development expense being offset by increased selling and marketing expense and reduced gross profit.

#### RESULTS OF OPERATIONS FOR THE YEARS ENDED DECEMBER 31, 1994 AND 1993

Revenues for 1994 totalled \$15,884,000, consisting of product revenues of \$14,787,000 and licensing revenues of \$1,097,000. This represented an overall decrease of 20% from the prior year. Product revenues decreased by 12% while licensing revenues decreased by 65%.

The decrease in product revenues was due mainly to a reduction in shipments to Scott Paper Company arising principally in the second quarter of 1994. This was compounded by the absence in 1994 of a \$766,000 non-recurring sale of analytical standards equipment that occurred in 1993. Overall revenues from consumer products including commissions increased by 2% over the prior year. Shipments of APS-marketed consumer products decreased slightly by \$277,000 or 3% in 1994 due mainly to a decrease in sales of sun care products. This was partially offset by a modest increase in shipments of Take-Off makeup remover which was reintroduced in the second half of the year as a Microsponge-enhanced product. Sales of the Exact OTC acne treatment were essentially flat with the prior year, which included initial stocking orders of two line extensions introduced during the year.

Licensing revenues decreased to \$1,097,000 from \$3,151,000. The prior year included a milestone payment of \$750,000 received from Johnson & Johnson, Inc. on a photodamage product and revenue of \$2,106,000 which was recognized in accordance with the percentage-of-completion method of accounting on milestone payments received from J&J in the prior year. Revenues in 1994 included the balance remaining under the percentage-of-completion method of \$894,000.

Gross profit for the year on product sales amounted to \$4,638,000 compared to \$3,941,000 in the prior year. Expressed as a percentage of product revenues, gross profit increased by eight percentage points over the prior year to 31%. This is attributable to increased manufacturing efficiencies at the Company's facility in Lafayette, Louisiana, and to the fact that higher margin consumer product sales represented a greater portion of overall product revenues.

Research and development expense decreased compared to the prior year by \$1,009,000 or 14% due both to cost-containment measures implemented in the fourth quarter of 1993 and reduced expenditures on clinical trials. This latter trend is expected to continue. The Company submitted its NDA for its UVA/UVB sun protection cream in September of 1994 and a second NDA for its tretinoin acne treatment in February 1995.

Selling and marketing expense decreased in 1994 by \$272,000 or 6% due mainly to reduced overhead expense at the Company's consumer products and analytical standards divisions. Advertising and promotion costs decreased by \$296,000 or 15% to \$1,657,000 as the Company moved from the more expensive print advertising to other forms of media, mainly point-of-sale. Advertising and promotion costs associated with current products and those to be launched in the future will depend on market sizes and perceived opportunities.

General and administrative expense decreased by \$144,000 or 5% due mainly to continuing cost control measures.

The loss on purchase commitment and inventory primarily relates to a contractual commitment for the purchase of melanin in excess of current estimated requirements. Melanin is a key ingredient in the manufacture of the APS developed UVA/UVB sun protection cream.

Interest income decreased to \$356,000 from \$560,000 in the prior year due to lower average cash balances. Other income decreased because the prior year included gains on disposal of equipment which the Company acquired as a result of the restructuring of its agreements with Rhone-Poulenc Rorer.

The Company incurred a net loss of \$9,759,000 for the year ended 1994. This was slightly below the loss of \$9,877,000 in the prior year with lower sales offset by a better gross profit mix and reduced operating expenses.

#### CAPITAL RESOURCES AND LIQUIDITY

Total assets as of December 31, 1995 were \$23,082,000 compared with \$23,508,000 at December 31, 1994. Working capital decreased to \$4,976,000 at December 31, 1995 from \$5,641,000 at December 31, 1994. In the same period, cash and cash equivalents and marketable securities increased to \$5,173,000 from \$4,517,000. The Company's primary investment objectives for those assets are the preservation of capital and the maintenance of a high degree of liquidity.

The Company has financed its operations, including product research and development, from amounts raised in debt and equity financings, the sale of consumer products, Microsponge delivery systems and analytical standard products; payments received under licensing agreements; and interest earned on short-term investments.

The Company raised \$9,117,000 from two private placements in 1994, and \$1,388,000 from a private placement in the first quarter of 1995.

In September 1995, the Company extinguished \$2,500,000 of Industrial Revenue Bonds through an "insubstance defeasance" transaction by placing approximately \$2,500,000 of U.S. government securities in an irrevocable trust to fund all future interest and principal payments. The purchase of the government securities was achieved through the sale of the Company's pledged marketable securities. The debt extinguishment did not have a material impact on the Company's earnings.

Also in the second half of 1995, the Company raised an aggregate amount of \$8,122,000 from three financing agreements. The first financing arrangement is a bank loan totalling \$3,000,000 with an interest rate equal to two percentage points above the Prime Rate. The loan is secured by the assets and operating cash flows of a subsidiary of the Company and guaranteed by the Company. The second financing arrangement is a \$1,500,000 term loan with a fixed interest rate of 14%. This loan is also secured by the assets and operating cash flows of a subsidiary of the Company and guaranteed by the Company. The security interest of the debt holders is subordinated to the bank loan's security.

interest. The third financing arrangement, aggregating \$3,622,000, resulted from the sale of certain real and personal properties that the Company subsequently leased back for a fixed rental stream over a period of forty-eight months. The Company reported this transaction as a financing transaction since the requirements for consummation of a sale were not met. The effective interest rate of this financing is approximately 11%.

During 1995, Company operations used approximately \$8,520,000 of cash. Approximately \$4,139,000 was invested in product research and development and \$1,805,000 was invested in advertising and promoting new products.

In prior years, cash was expended with regard to Phase III clinical tests of tretinoin entrapped in a Microsponge delivery system for the treatment of acne, and of APS' melanin-Microsponge sunscreen product, together with related research and development costs, all of which decreased substantially in 1995 following the filing of the respective NDAs. Additionally, the Company is contractually obligated to purchase minimum annual quantities of melanin. Failure to purchase the minimum quantities results in a mandatory payment of \$600,000 to its melanin supplier under "take or pay" provisions. In February 1995, the Company received a milestone payment of \$1,500,000 from Ortho Pharmaceutical Corporation upon the filing of its NDA on the tretinoin acne treatment.

Additionally, in 1995 the Company received \$748,000 from the sale of an idle facility in Vacaville, California. The Company recorded a loss on the sale of approximately \$126,000.

The Company's existing cash and cash equivalents, collections of trade accounts receivable, together with interest income and other revenue producing activities including milestone payments, are expected to be sufficient to meet the Company's near-term cash requirements assuming no changes to existing business plans. The Company is also currently developing a variety of opportunities which would generate additional funds including joint ventures, equity financings, licensing agreements and other financing activities.

In the unlikely event that the Company is unable to raise additional funds required to finance its operations, operating costs will have to be significantly reduced by decreasing spending on advertising and promotion activities, outside clinical programs and a variety of other discretionary external expenditures.

#### NEW ACCOUNTING STANDARD

Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation", must be adopted for years beginning after December 15, 1995. This standard defines a fair-value-based method of accounting for stock-based employee compensation plans; however, it also allows an entity to continue to measure compensation cost for those plans using the provisions of APB Opinion No. 25, "Accounting for Stock Issued to Employees" ("Opinion 25"). Under the fair value based method, compensation cost is measured at the grant date based on the fair value of the award and is recognized over the service period, which is usually the vesting period. Under Opinion 25, compensation cost is recognized based on the difference, if any, between the market price of the stock and the amount an employee must pay to acquire the stock. Entities

electing to remain with the accounting in Opinion 25 must make pro forma disclosures of net income and earnings per share, as if the fair value method defined in this standard had been applied. The Company has elected to continue accounting for compensation cost arising from its stock-based compensation plans under the Opinion 25 approach, and will therefore present the pro forma disclosures required by the standard in its financial statements for the year ending December 31, 1996.

Item 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA  
Advanced Polymer Systems, Inc. and Subsidiaries  
CONSOLIDATED BALANCE SHEETS

December 31, ASSETS	1995	1994
Current Assets:		
Cash and cash equivalents	\$ 5,172,809	\$ 2,741,994
Marketable securities	--	1,775,502
Pledged marketable securities	--	1,945,620
Accounts receivable less allowance for doubtful accounts of \$68,650 and \$66,564 at December 31, 1995 and 1994, respectively	2,436,815	1,887,388
Accrued interest receivable	16,473	26,043
Inventory	7,858,584	7,002,026
Prepaid expenses and other	985,199	1,006,130
Total current assets	16,469,880	16,384,703
Property and equipment, net	5,027,034	5,106,525
Assets held for sale	--	923,436
Deferred loan costs, net	832,324	52,685
Prepaid license fees, net	303,638	441,506
Goodwill, net of accumulated amortization of \$616,387 and \$455,590 at December 31, 1995 and 1994, respectively	187,596	348,393
Other long-term assets	261,770	250,914
<b>TOTAL ASSETS</b>	<b>\$ 23,082,242</b>	<b>\$ 23,508,162</b>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	\$ 3,240,807	\$ 2,584,161
Accounts payable, Johnson & Johnson	4,229,637	3,570,525
Accrued expenses	1,819,541	1,731,545
Accrued melanin purchase commitments	600,000	657,248
Current portion - long-term debt	853,987	2,200,000
Deferred revenue	750,000	--
Total current liabilities	11,493,972	10,743,479
Long-term debt	6,354,969	978,935
<b>TOTAL LIABILITIES</b>	<b>17,848,941</b>	<b>11,722,414</b>
COMMITMENTS AND CONTINGENCIES		
SHAREHOLDERS' EQUITY		
Preferred stock, authorized 2,500,000 shares; none issued or outstanding at December 31, 1995 and 1994	--	--
Common stock, \$.01 par value, authorized 50,000,000 shares; issued and outstanding 16,594,565 and 16,043,121 at December 31, 1995 and 1994, respectively	165,946	160,431
Common stock to be issued, \$.01 par value, 432,101 shares issuable in 1996	4,321	--
Warrants, issued and outstanding: 1,628,611 at December 31, 1995 and 2,286,658 at December 31, 1994	2,653,076	4,059,500
Additional paid-in capital	64,600,516	60,297,027
Unrealized gain on securities	12,348	113,166
Accumulated deficit	(62,202,906)	(52,844,376)
<b>TOTAL SHAREHOLDERS' EQUITY</b>	<b>5,233,301</b>	<b>11,785,748</b>
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$ 23,082,242</b>	<b>\$ 23,508,162</b>

See accompanying notes

Advanced Polymer Systems, Inc. and Subsidiaries  
CONSOLIDATED STATEMENTS OF OPERATIONS

For the Years Ended December 31,	1995	1994	1993
Revenues:			
Product revenues	\$ 15,203,196	\$ 14,787,048	\$ 16,780,598
Licensing revenues	905,000	1,097,402	3,151,000
	16,108,196	15,884,450	19,931,598
Total revenues			
Expenses:			
Cost of sales	11,047,399	10,149,302	12,840,205
Research and development, net	4,139,441	6,334,168	7,342,601
Selling and marketing	4,755,788	4,011,752	4,283,657
Advertising and promotion	1,804,540	1,657,178	1,953,042
General and administrative	3,081,900	2,844,282	2,988,284
Loss on purchase commitment, including related inventory	600,000	685,000	950,000
	(9,320,872)	(9,797,232)	(10,426,191)
Operating loss			
Other income (expense), net	89,895	(38,593)	288,929
Interest income	317,948	355,837	560,104
Interest expense	(445,501)	(278,988)	(299,973)
	\$ (9,358,530)	\$ (9,758,976)	\$ (9,877,131)
Net loss			
Loss per common share	\$ (0.57)	\$ (0.65)	\$ (0.73)
Weighted average common shares outstanding	16,459,446	15,017,753	13,527,207

See accompanying notes.

Advanced Polymer Systems, Inc. and Subsidiaries  
 CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

For the Years Ended  
 December 31, 1995, 1994, 1993

	Common Stock		Common Stock Warrants		Additional Paid-In Capital	Unrealized Holding Gain
	Shares	Amount	Shares	Amount		
Balance December 31, 1992	13,440,654	\$ 134,406	1,161,500	\$ 2,300,000	\$ 50,790,569	\$ --
Options exercised	211,639	2,117	--	--	321,221	--
Shares retired	(5,636)	(56)	--	--	(34,449)	--
Net loss	--	--	--	--	--	--
Distributions	--	--	--	--	--	--
1993 Total	206,003	2,061	--	--	286,772	--
Balance December 31, 1993	13,646,657	\$ 136,467	1,161,500	\$ 2,300,000	\$ 51,077,341	\$ --
Options exercised	471,306	4,713	--	--	1,881,821	--
Agreement with Johnson & Johnson, net of \$30,201 in offering costs	1,000,000	10,000	200,000	285,000	4,674,799	--
Private placement, net of \$353,183 in offering costs	925,158	9,251	925,158	1,474,500	2,663,066	--
Unrealized holding gain	--	--	--	--	--	113,166
Net loss	--	--	--	--	--	--
Distributions	--	--	--	--	--	--
1994 Total	2,396,464	23,964	1,125,158	1,759,500	9,219,686	113,166
Balance December 31, 1994	16,043,121	\$ 160,431	2,286,658	\$ 4,059,500	\$ 60,297,027	\$ 113,166
Options exercised	236,992	2,370	--	--	1,078,929	--
Private placement, net of \$112,383 in offering costs	310,278	3,103	310,278	485,591	898,923	--
Securities issued in debt financing arrangements	4,174	42	193,175	407,985	29,958	--
Common Stock to be issued in connection with the agreement with Johnson & Johnson	432,101	4,321	--	--	(4,321)	--
Warrants expired	--	--	(1,161,500)	(2,300,000)	2,300,000	--
Unrealized holding gain	--	--	--	--	--	(100,818)
Net loss	--	--	--	--	--	--
1995 Total	983,545	9,836	(658,047)	(1,406,424)	4,303,489	(100,818)
Balance December 31, 1995	17,026,666	\$ 170,267	1,628,611	\$ 2,653,076	\$ 64,600,516	\$ 12,348

For the Years Ended  
 December 31, 1995, 1994, 1993

	Accumulated Deficit	Total Shareholders' Equity
Balance December 31, 1992	\$(33,081,570)	\$ 20,143,405
Options exercised	--	323,338
Shares retired	--	(34,505)
Net loss	(9,877,131)	(9,877,131)
Distributions	(53,699)	(53,699)
1993 Total	(9,930,830)	(9,641,997)
Balance December 31, 1993	\$(43,012,400)	\$ 10,501,408
Options exercised	--	1,886,534
Common stock to be issued in connection with agreement with Johnson & Johnson, net of \$30,201 in offering costs	--	4,969,799
Private placement, net of \$353,183 in offering costs	--	4,146,817
Unrealized holding gain	--	113,166
Net loss	(9,758,976)	(9,758,976)
Distributions	(73,000)	(73,000)
1994 Total	(9,831,976)	1,284,340
Balance December 31, 1994	\$(52,844,376)	\$ 11,785,748

Options exercised	--	1,081,299
Private placement, net of \$112,383 in offering costs	--	1,387,617
Securities issued in debt financing arrangements	--	437,985
Common stock to be issued in connection with the agreement with Johnson & Johnson	--	--
Warrants expired	--	--
Unrealized holding gain	--	(100,818)
Net loss	(9,358,530)	(9,358,530)
	-----	-----
1995 Total	(9,358,530)	(6,552,447)
	-----	-----
Balance December 31, 1995	\$(62,202,906)	\$ 5,233,301
	=====	=====

See accompanying notes.

Advanced Polymer Systems, Inc. and Subsidiaries  
CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Years Ended December 31,	1995	1994	1993
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net loss	\$ (9,358,530)	\$ (9,758,976)	\$ (9,877,131)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	1,377,614	1,243,906	1,202,230
Provision for loss on purchase commitments, including inventory	600,000	685,000	850,000
Change in allowance for doubtful accounts	2,086	(69,456)	106,888
Accretion of pledged long-term marketable securities	(121,572)	(150,498)	(138,243)
(Gain) loss on sale of equipment and assets held for sale	125,764	(868)	(195,914)
Gain on sale of pledged marketable securities	(234,319)	--	--
Changes in operating assets and liabilities:			
Accounts receivable	(1,130,448)	908,738	(1,116,787)
Accrued interest receivable	9,570	6,981	172,009
Inventory	(856,558)	1,291,126	(5,065,950)
Prepaid expenses and other	20,931	(575,003)	(419,645)
Deferred charges loan costs	(439,824)	--	--
Other long-term assets	(10,856)	17,895	(20,704)
Accounts payable and accrued expenses	87,394	517,005	1,603,855
Accounts payable, Johnson & Johnson	659,112	(1,852,753)	3,205,707
Deferred revenue	750,000	(894,000)	(2,106,000)
<b>NET CASH USED IN OPERATING ACTIVITIES</b>	<b>(8,519,636)</b>	<b>(8,630,903)</b>	<b>(11,799,685)</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Purchase of property and equipment	(901,288)	(645,899)	(1,220,185)
Proceeds from sale of equipment and assets held for sale	797,672	2,290	518,667
Purchases of marketable securities	(4,458,891)	(1,448,467)	(6,540,855)
Maturities and sales of marketable securities	5,935,087	1,216,394	18,063,192
<b>NET CASH PROVIDED FROM (USED IN) INVESTING ACTIVITIES</b>	<b>1,372,580</b>	<b>(875,682)</b>	<b>10,820,819</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Repayment to Dow Corning	--	(274,208)	(98,391)
Repayment of long-term debt	(258,304)	(200,000)	(200,000)
Proceeds from long-term debt and warrants	7,367,259	--	--
Proceeds from private placement, net of offering costs	1,387,617	4,146,817	--
Proceeds from agreement with Johnson & Johnson	--	4,969,799	--
Distributions	--	(73,000)	(53,699)
Proceeds from the exercise of common stock options, net of common stock retired	1,081,299	1,886,534	288,833
<b>NET CASH PROVIDED FROM (USED IN) FINANCING ACTIVITIES</b>	<b>9,577,871</b>	<b>10,455,942</b>	<b>(63,257)</b>
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	<b>2,430,815</b>	<b>949,357</b>	<b>(1,042,123)</b>
Cash and cash equivalents at the beginning of the year	2,741,994	1,792,637	2,834,760
<b>Cash and cash equivalents at the end of the year</b>	<b>\$ 5,172,809</b>	<b>\$ 2,741,994</b>	<b>\$ 1,792,637</b>

Supplemental disclosure of non-cash financing transactions:

In September 1995, the Company offset its note payable to Dow Corning Corporation ("DCC") against its receivable from DCC. This resulted in a decrease in long-term debt, short-term debt and accounts receivable of \$478,935, \$100,000 and \$578,935, respectively.

In September 1995, the Company extinguished a debt through an insubstance defeasance transaction by placing U.S. government securities in an irrevocable trust to fund all future scheduled payments on the debt (Note 7).

See accompanying notes.

ADVANCED POLYMER SYSTEMS, INC. AND SUBSIDIARIES  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 December 31, 1995, 1994 and 1993

NOTE 1 BUSINESS

Advanced Polymer Systems, Inc. ("APS" or the "Company") develops, manufactures and sells patented delivery systems that allow for the controlled release of active ingredients in a programmed manner in the ethical dermatology, cosmetic and personal care areas. Certain projects are conducted under development and licensing arrangements with large companies, others are part of joint ventures in which APS is a major participant, and a number of projects are exclusive to APS. APS also markets and distributes a range of in-licensed consumer products for personal care through its subsidiary, Premier, Inc. ("Premier").

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**Principles of Consolidation:** The consolidated financial statements include the financial statements of the Company and its wholly owned subsidiaries, Premier, APS Analytical Standards and APS Joint Venture Corporation. All significant intercompany balances and transactions have been eliminated in consolidation.

On April 2, 1993, APS acquired Premier, a marketing and distribution company specializing in over-the-counter drug and personal care products. The business combination was accounted for as a pooling of interests and, accordingly, the Company's historical consolidated financial statements have been restated to include the accounts and results of Premier for all periods presented.

**Cash Equivalents and Marketable Securities:** For purposes of the Consolidated Statements of Cash Flows and Consolidated Balance Sheets, the Company considers all short-term investments that have original maturities of less than three months to be cash equivalents. Short-term investments consist primarily of certificates of deposit, commercial paper, master notes and repurchase agreements. Investments which have original maturities longer than three months are classified as marketable securities in the accompanying Consolidated Balance Sheets. The Company has classified its investments in certain debt and equity securities as "available-for-sale". Such investments are recorded at fair value with unrealized holding gains and losses reported as a separate component of stockholders' equity.

**Inventory:** Inventory is stated at the lower of cost or market value, utilizing the average cost method (Note 5).

**Property and Equipment:** Property and equipment are carried at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets, not exceeding twenty years (Note 6).

**Prepaid License Fees:** The fee paid in 1992 to ROCEP Pressure Packs of Scotland for the exclusive right to supply the Microsponge delivery system in an environmentally friendly aerosol is being amortized over the five-year length of the contract on a straight-line basis. The fee paid to Biosource Technologies, Inc. ("Biosource") in 1992 is being amortized over a seven-year term consistent with the term of the related minimum purchase commitments (Notes 3 and 8). Amortization of prepaid license fees totalled \$137,868, \$124,057 and \$120,244 in 1995, 1994 and 1993, respectively.

**Deferred Charges:** Deferred Charges relate to costs incurred in obtaining certain loans. These charges are being amortized over the life of the loans using the effective interest method (Note 7).

**Long-Lived Assets, Including Goodwill:** In accordance with SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of", the Company evaluates whether changes have occurred that would require revision of the remaining estimated lives of recorded long-lived assets, including goodwill, or render those assets not recoverable. If such circumstances arise, recoverability is determined by comparing the undiscounted net cash flows of long-lived assets to their respective recorded net book values. The amount of impairment, if any, is measured based on the projected discounted cash flows using an appropriate discount rate. At this time, the Company believes that no significant impairment of long-lived assets, including goodwill, has occurred and that no reduction of the estimated useful lives of such assets is warranted.

In 1992, APS acquired for 157,894 shares of its common stock, the outstanding 25% interest in ACP, APS' over-the-counter

consumer products subsidiary. The acquisition was accounted for as a purchase. Excess of cost over net assets acquired arising from the purchase is being amortized over five years on a straight-line basis. Amortization of goodwill totalled \$160,797, \$160,796, and \$160,797 in 1995, 1994 and 1993, respectively.

Advertising and Promotion Costs: Advertising costs are expensed as incurred.

Earnings (Loss) per Share: Earnings (loss) per common share are based on the weighted average number of common and common equivalent shares outstanding during each year. The computation assumes that no outstanding stock options and warrants were exercised as they would be anti-dilutive.

Licensing Agreements: The Company has several licensing agreements that generally provide for monthly payments, periodic minimum payments and royalties for exclusivity. Revenue is recorded as services are performed. The agreements do not contain any financial obligations with respect to the Company at the expiration or earlier termination of the agreements. Certain agreements also require the remittance of non-refundable milestone fees. Such fees and option payments aggregated \$750,000, \$0 and \$750,000 in 1995, 1994 and 1993, respectively.

Deferred Revenue: Prepaid royalties paid to APS by Ortho Pharmaceutical Corporation ("Ortho"), a subsidiary of Johnson & Johnson Inc. ("J&J"), as part of the retinoid licensing agreement are reported as deferred revenues. (Note 12)

Concentrations of Credit Risk: Financial instruments which potentially expose the Company to concentrations of credit risk, as defined by Statement of Financial Accounting Standards No. 105, consist primarily of trade accounts receivable. As of December 31, 1995, approximately 43% of the recorded trade receivables were concentrated with three customers in the cosmetic and personal care industries. To reduce credit risk, the Company performs ongoing credit evaluations of its customers' financial conditions. The Company does not generally require collateral.

Reclassifications: Certain reclassifications have been made to the prior year financial statements to conform with the presentation in 1995.

#### NOTE 3 RELATED PARTY TRANSACTIONS

APS has entered into agreements with Biosource. Two directors serve on the Board of Directors of both Biosource and APS. All agreements between APS and Biosource have been, and will continue to be, considered and approved by a vote of the disinterested directors. The agreements provide APS worldwide rights to use and sell Biosource's biologically-synthesized melanin in Microsponge systems for all sun protection, cosmetic, ethical dermatology and over-the-counter skin care purposes. In return, APS is required to make annual minimum purchases of melanin (Note 8), pay royalties on sales of APS melanin-Microsponge products and was required to prepay \$500,000 of royalties. During 1995, the Company paid Biosource \$3,329 in royalties and accrued \$600,000 for estimated loss on future purchase commitments. During 1994, APS paid Biosource \$3,279 prepaid royalties and \$263,403 for the supply of melanin. The 1994 financial results also included a \$685,000 provision for the estimated loss on certain future purchase commitments and related inventory on hand for product in excess of estimated requirements. During 1993, the Company paid or accrued \$893,485 for the supply of melanin, an additional \$200,000 to meet the annual minimum purchase commitment, and \$40,820 for royalties on product sales. The 1993 financial results also included a \$750,000 provision for the estimated loss on certain future purchase commitments and related inventory on hand for product in excess of estimated requirements.

## NOTE 4 CASH EQUIVALENTS AND MARKETABLE SECURITIES

At December 31, 1995 and 1994, the amortized cost and estimated market value of investments in debt securities are set forth in the tables below:

	December 31, 1995			
	Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Available-for-Sale:				
Corporate debt securities	\$3,273,602	\$ 12,348	-	\$3,285,950
Other debt securities	164,425	--	-	164,425
Totals	\$3,438,027	\$ 12,348	-	\$3,450,375

	December 31, 1994			
	Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Available-for-Sale:				
U.S. Government debt securities	\$2,132,604	\$101,682	-	\$2,234,286
Corporate debt securities	1,555,352	11,484	-	1,566,836
Other debt securities	1,945,453	--	-	1,945,453
Totals	\$5,633,409	\$113,166	-	\$5,746,575

The table below reflects the balance sheet classification of investments in debt securities at December 31:

	1995		1994	
	Cost	Fair Value	Cost	Fair Value
Cash equivalents	\$3,438,027	\$3,450,375	\$2,025,453	\$2,025,453
Marketable securities	--	--	1,761,139	1,775,502
Pledged marketable securities	--	--	1,846,817	1,945,620
Totals	\$3,438,027	\$3,450,375	\$5,633,409	\$5,746,575

Available-for-sale debt securities as of December 31, 1995, are all due in less than three months.

## NOTE 5 INVENTORY

The major components of inventory are as follows:

	December 31, 1995	December 31, 1994
Raw materials and work-in-process	\$1,006,847	\$1,019,427
Finished goods	6,851,737	5,982,599
Total inventory	\$7,858,584	\$7,002,026

J&J has a security interest in the Company's Sundown(R) and Johnson's Baby Sunblock(R) inventory. Inventory subject to their security interest totalled approximately \$4,400,000 and \$3,600,000 at December 31, 1995 and 1994, respectively (Note 14).

## NOTE 6 PROPERTY AND EQUIPMENT

Property and equipment consist of the following:

	December 31, 1995	December 31, 1994
Building	\$ 1,610,339	\$ 1,594,979
Land and improvements	163,519	163,519
Leasehold improvements	571,223	571,223
Furniture and equipment	10,623,203	9,737,275
Total property and equipment	\$ 12,968,284	\$ 12,066,996
Accumulated depreciation and amortization	(7,941,250)	(6,960,471)
Property and equipment, net	\$ 5,027,034	\$ 5,106,525

Depreciation expense amounted to \$980,779, \$920,871 and \$880,236 for the years ended December 31, 1995, 1994, and 1993, respectively.

In 1992, the Company obtained ownership of a manufacturing facility as part of a settlement of a joint venture. The Company sold this facility in 1995 and recorded a loss on the sale of approximately \$126,000.

#### NOTE 7 LONG-TERM DEBT

Long-term debt consists of the following:

	December 31, 1995	December 31, 1994
Bank loan, interest payable monthly, principal due in non-equal installments commencing December 1, 1996 through March 1, 1999, secured by the assets and operating cash flow of a subsidiary of the Company and guaranteed by the Company	\$3,000,000	\$ --
Term loan, subordinated to bank loan, interest payable quarterly, principal due in non-equal installments commencing December 1, 1996 through March 1, 1999, secured by the assets and operating cash flows of a subsidiary of the Company and guaranteed by the Company	1,500,000	--
Term loan, principal and interest due in equal monthly installments commencing October 1995 through December 1999, secured by certain real and personal property	2,708,956	--
Industrial Revenue Bonds, interest payable quarterly, principal due in non-equal semi-annual installments, commencing June 30, 1993, through December 31, 2000, secured by pledged marketable securities, and certain real and personal property	--	2,600,000
Advance from Dow Corning Corporation, non-interest bearing, to be repaid out of the gross profits of certain future sales, but in no case later than December 11, 1996, subordinated to the Industrial Revenue Bonds, notes payable, and secured by certain real and personal property	--	578,935
Total	\$7,208,956	\$3,178,935
Less current portion	853,987	2,200,000
Long-term debt	\$6,354,969	\$ 978,935

Maturities of the long-term debt are as follows:

Years ending December 31:	Amount
1996	\$ 853,987
1997	1,470,780
1998	2,473,389
1999	2,410,800
	-----
	\$7,208,956
	=====

In 1995, the Company received an aggregate amount of \$8,122,334 from three financing arrangements.

The first financing arrangement is a \$3,000,000 bank loan with an interest rate equal to two percentage points above the Prime Rate (8.5% as of December 31, 1995). The loan is secured by the assets and operating cash flows of a subsidiary of the Company and guaranteed by the Company.

The second financing arrangement is a \$1,500,000 term loan with a syndicate of lenders and a fixed interest rate of 14%. The loan is also secured by the assets and operating cash flows of a subsidiary of the Company and guaranteed by the Company. The security interest of the debt holders is subordinated to the bank loan's security interest.

In the third quarter of 1995, the Company consummated a transaction whereby certain real and personal properties were sold to a third party and subsequently leased back for a fixed rental stream over a period of forty-eight months. The Company has the option either to purchase all the properties at the expiration of the term of the lease or extend the term of the lease. The Company reported this transaction as a financing transaction since the requirements for consummation of a sale were not met. A deposit of \$755,000 with the lender was offset against the loan balance as of December 31, 1995. This deposit earns an interest rate of 4%. This transaction has been reflected in the table above as a term loan.

The terms of certain financing agreements contain among other provisions, requirements for a subsidiary of the Company to maintain defined levels of earnings, net worth and various financial ratios, including net worth. In conjunction with the debt financing agreements, APS issued a total of 193,175 warrants with an exercise price of \$7.00 per share of common stock.

All costs incurred in obtaining the financing arrangements have been capitalized as deferred charges, and are being amortized over the life of the loans using the effective interest method. Interest paid in 1995, 1994 and 1993 approximated interest expense reflected in the Consolidated Statements of Operations.

In September 1995, the Company extinguished \$2,500,000 of Industrial Revenue Bonds through an "insubstance defeasance" transaction by placing approximately \$2,500,000 of U.S. government securities in an irrevocable trust to fund all future interest and principal payments. The purchase of the government securities was achieved through the sale of the Company's pledged marketable security. The debt extinguishment did not have a material impact on the Company's earnings. The debt balance outstanding as of December 31, 1995 was \$2,500,000.

In 1995, the Company offset its note payable to Dow Corning Corporation ("DCC") against its receivable from DCC as agreed by both companies.

#### NOTE 8 COMMITMENTS

Lease Commitments: Total rental expense for property and equipment was \$639,807, \$558,086 and \$578,208 for 1995, 1994 and 1993, respectively.

The Company's future minimum lease payments under noncancellable operating leases for facilities as of December 31, 1995, are as follows:

Years ending December 31,	Minimum Payments -----
1996	\$442,037
1997	362,184
1998	51,441
1999	17,638
	-----
	\$873,300
	=====

Supply Agreements: The Company has entered into agreements with Biosource. APS is required to make annual minimum purchases of melanin and pay royalties on sales of APS melanin-Microsponge products (Note 3). The minimum financial commitments not yet expensed by APS under the current agreements are \$600,000 per annum for each of the years in the two year period ending December 31, 1998, in aggregate \$1,200,000.

#### NOTE 9 SHAREHOLDERS' EQUITY

Private Placements and Common Stock Warrants: In 1994, the Company raised \$9,116,616 net of offering costs through two private placements. In the first private placement, APS issued 1,000,000 shares of newly issued common stock to Johnson & Johnson Development Corporation ("JJDC"), a subsidiary of Johnson & Johnson, Inc. in consideration for \$5,000,000. In addition, JJDC received 200,000 warrants exercisable for two years at \$12.00 per share. APS will be issuing JJDC an additional 432,101 shares in 1996 as a result of the APS stock price not achieving certain predetermined levels.

The second private placement was pursuant to an agreement for the sale of up to \$8,000,000 of common stock and warrants in six installments beginning in June 1994 and ending on September 29, 1995. The Company sold \$6,000,000 of common stock and warrants through March 30, 1995. The remaining two optional installments in June and September 1995 totalling \$2,000,000 of common stock and warrants were not sold by the Company. In accordance with the agreement, the following shares of common stock and warrants were issued:

Date Issued -----	Number of Shares of Common Stock Issued -----	Number of Warrants Issued -----	Exercise Price of Warrants -----
June 30, 1994	294,314	294,314	\$5.61
September 30, 1994	299,066	299,066	\$5.52
December 31, 1994	331,778	331,778	\$4.97
March 30, 1995	310,278	310,278	\$5.32

The warrants issued are exercisable over a three-year period. The value of the warrants was determined using the Black-Scholes model.

In conjunction with certain debt financing agreements made in 1995 (Note 7), APS issued a total of 193,175 warrants with an exercise price of \$7.00 per share of common stock. These warrants expire on March 27, 2000.

In the first quarter of 1995, 1,161,500 warrants which were issued in a 1992 private placement expired.

Stock Options: The Company has various stock option plans for employees, officers, directors and consultants. The options are granted at fair market value and expire no later than ten years from the date of the grant. The options are exercisable in accordance with vesting schedules that generally provide for them to be fully exercisable four years after the date of grant.

The following table summarizes option activity for 1995, 1994 and 1993:

-----  
Option shares,

December 31, -----	1995 -----	1994 -----	1993 -----
Outstanding at beginning of year	2,677,162	2,688,940	2,330,829
Granted	486,500	623,500	715,000
Exercised	(236,992)	(471,306)	(211,639)
Expired or cancelled	(104,346)	(163,972)	(145,250)
-----	-----	-----	-----
Outstanding at end of year	2,822,324	2,677,162	2,688,940
-----	-----	-----	-----
Option shares exercisable, December 31	1,877,295	1,529,574	1,607,539
-----	-----	-----	-----
Shares available for future grant, December 31	317,819	707,973	1,279,750
-----	-----	-----	-----
Option price per share:			
Granted	\$ 5.000 - \$ 6.500	\$ 4.250 - \$ 6.125	\$ 5.250 - \$ 8.125
Exercised	\$ 3.000 - \$ 5.438	\$ 3.750 - \$ 6.500	\$ 0.250 - \$ 4.350
Outstanding, December 31	\$ 3.000 - \$11.125	\$ 3.000 - \$11.125	\$ 3.000 - \$11.125

Distributions: Distributions presented in the Consolidated Statements of Shareholders' Equity represent payments to the shareholders of Premier, which was a subchapter S Corporation. Premier's S Corporation election was terminated in conjunction with the merger (Note 13).

#### NOTE 10 DEFINED CONTRIBUTION PLAN

The Company sponsors a defined contribution plan covering substantially all of its employees. In 1995, the Company made matching contributions equal to 50% of each participant's contribution during the plan year up to a maximum amount equal to the lesser of 3% of each participant's annual compensation or \$4,620 for the calendar year. In the prior years, the maximum matching contribution made by the Company was equal to the lesser of 1.5% of each participant's salary or \$1,000 per calendar year. The Company may also contribute additional discretionary amounts as it may determine. For the years ended December 31, 1995, 1994 and 1993, the Company contributed to the plan approximately \$89,000, \$55,000 and \$40,000, respectively. No discretionary contributions have been made to the plan since its inception.

#### NOTE 11 INCOME TAXES

A reconciliation of the Federal statutory rate of 34% to the Company's effective tax rate is as follows:

	1995 -----	December 31 1994 -----	1993 -----
U.S. Federal statutory rate (benefit)	(34.0)%	(34.0)%	(34.0)%
Losses without tax benefits	33.5	34.0	34.0
State income taxes, net of U.S.			
Federal income tax effect	--	--	--
Nondeductible expenses	0.5	--	--
-----	-----	-----	-----
Total tax expense	--	--	--
=====	=====	=====	=====

At December 31, 1995, the Company had net Federal operating loss carry forwards of approximately \$63,000,000 for income tax reporting purposes and California state operating loss carry forwards of approximately \$8,800,000. The Federal net operating loss carry forwards expire beginning in 1998 through the year 2010. The California net operating loss carry forwards expire beginning in 1996 through the year 2000. A California net operating loss carry forward from 1988 in the approximate amount of \$2,200,000 expired December 31, 1995.

Due to the "change in ownership" provisions of the Tax Reform Act of 1986, approximately \$32,000,000 and \$5,500,000 of the Company's Federal and California net operating loss carry forwards, respectively, are subject to an annual limitation against taxable income. The balance of the Federal and California loss carry forwards of approximately \$31,000,000 and \$3,300,000, respectively, which arose subsequent to the Company's change in ownership will be fully available to offset taxable income in excess of the annual limitation until fully utilized or there is another ownership change.

The Company also has investment tax credit/carryovers and research and experimental tax credits aggregating approximately \$1,692,000 and \$572,000 for Federal and California purposes, respectively, of which approximately \$663,000 and \$139,000, respectively, are also subject to an annual limitation due to the "change in ownership" provisions of the Tax Reform Act of 1986. The Federal credits expire beginning in 1998 through the year 2010. The California credits carry over indefinitely until utilized.

There are also California credit carry forwards for qualified manufacturing and research and development equipment of approximately \$10,000; these credits expire in 2005.

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 1995 and 1994 are presented below:

	1995 ----	1994 ----
Deferred tax assets:		
Deferred research expenditures	\$ 1,443,000	\$ 765,000
Accruals and reserves not currently deductible for tax purposes	1,197,000	953,000
Net operating loss carry forward	22,283,000	19,061,000
Credit carry forwards	2,274,000	2,051,000
Other	572,000	175,000
	-----	-----
Gross deferred tax assets	27,769,000	23,005,000
Less valuation allowance	(27,426,000)	(22,892,000)
	-----	-----
Total deferred tax assets	\$ 343,000	\$ 113,000
	-----	-----
Deferred tax liabilities:		
Property and equipment	\$ (343,000)	\$ (113,000)
	-----	-----
Total deferred tax liabilities	(343,000)	(113,000)
	-----	-----
Net deferred taxes	\$ --	\$ --
	=====	=====

The net change in the valuation allowance for the years ended December 31, 1995 and 1994 was an increase of approximately \$4,534,000 and \$3,627,000, respectively. Management believes that sufficient uncertainty exists regarding the realizability of these items and, accordingly, a valuation allowance is required.

Gross deferred tax assets as of December 31, 1995 include approximately \$2,329,000 relating to the exercise of stock options, which will be credited to equity when realized.

#### NOTE 12 ORTHO PHARMACEUTICAL CORPORATION

In May 1992, APS entered into development and licensing and investment agreements with Ortho for the development of retinoid products. The first product under development is a Microsponge system entrapment of tretinoin (trans-retinoic acid or "t-RA"), a prescription acne drug. A second product licensed to Ortho is a Microsponge entrapment of a retinoid to be used for the treatment of photodamaged skin.

The terms of the agreements included an \$8,000,000 investment in APS for 723,006 newly issued shares of APS common stock and the payment to APS of \$6,000,000 in licensing fees by J&J. The licensing fees were recognized as revenues according to the percentage-of-completion method of accounting whereby income was recognized based on the estimated stage of completion of the related project. Cash payments received in advance of being earned were classified as deferred revenue. Revisions of estimated profits have been included in earnings by the reallocation method which spread the change in estimate over the current and future periods. As of December 31, 1994, the project had been completed and all associated revenues had been recognized.

J&J made a second equity investment in the Company in May 1994 through its subsidiary Johnson & Johnson Development Corporation ("JJDC"). Under this agreement, JJDC purchased 1,000,000 shares of newly issued common stock in consideration for \$5,000,000. In addition, JJDC received 200,000 warrants exercisable for two years at \$12.00 per share. APS will be issuing JJDC an additional 432,101 shares in 1996 as a result of the APS stock price not achieving certain predetermined levels. Upon issuance of these additional shares, J&J's holding in APS common stock will increase to approximately 13% of common shares outstanding.

In February 1995, APS received \$750,000 in prepaid royalties and an additional \$750,000 as a milestone payment on the submission to the FDA of its New Drug Application for the tretinoin prescription acne treatment. The milestone payment was recognized as revenue upon receipt. The prepaid royalties of \$750,000 were recorded as deferred revenues. APS has the ability to earn an additional \$7,750,000 in fees if research milestones are achieved. If and when approval is received from the FDA to market the Microsponge tretinoin products, APS will earn a mark-up on Microsponge systems supplied to Ortho and J&J will pay APS a royalty on product sales, subject to certain minimums. Should these minimums not be achieved, Ortho loses its exclusivity and APS regains marketing rights to the retinoid products.

NOTE 13 PREMIER, INC.

On April 2, 1993, APS acquired Premier, a marketing and distribution company specializing in over-the-counter drug and personal care products. APS exchanged 454,444 shares of common stock for all the shares of Premier. The business combination was accounted for as a pooling of interests, and accordingly, the Company's historical consolidated financial statements presented herein are restated to include the accounts and results of operations of Premier.

The results of operations previously reported by the separate enterprises and the combined amounts presented in the accompanying consolidated financial statements are summarized below:

Year Ended December 31, -----	1993 ----
Total revenues:	
Advanced Polymer Systems, Inc.	\$ 12,002,807
Premier, Inc.	7,928,791
	-----
Combined	\$ 19,931,598
	-----
Net loss:	
Advanced Polymer Systems, Inc.	\$ (8,729,627)
Premier, Inc.	(1,147,504)
	-----
Combined	\$ (9,877,131)
	-----

NOTE 14 JOHNSON & JOHNSON

Licensing Agreement: The Company's wholly owned subsidiary, Premier, licensed from J&J the exclusive right to manufacture and distribute a product, Take-Off, in the U.S. The agreement provides for Premier to remit royalty payments to J&J based on net sales, with minimum payments of \$375,000 per year. This agreement expires in 1996 and provides an option for Premier to extend the term.

Distribution Arrangement: Premier obtained the rights to market and distribute two suncare products, Sundown and Johnson's Baby Sunblock, in the U.S. Premier purchases all Sundown inventory from J&J at an agreed-upon price. Premier is reimbursed by J&J for agreed-upon marketing expenses. Upon the termination of the arrangement, Premier is required to sell to J&J all of the J&J product in Premier's inventory at Premier's then current book value. Premier performs a reconciliation of the payable to J&J annually to determine the portion that is currently due. The portion of the payable that relates to inventory sold during a contract year is due at the end of that contract year.

NOTE 15 SUBSEQUENT EVENTS AND MANAGEMENT'S PLANS WITH RESPECT TO FUNDING OF OPERATIONS

In the first quarter of 1996, APS acquired all rights to the Polytrap technology from Dow Corning in exchange for 200,000 shares of APS Common Stock.

The Company's existing cash and cash equivalents, collection of trade accounts receivable, together with interest income and other revenue producing activities including milestone payments, are expected to be sufficient to meet the Company's near-term cash requirements assuming no changes to existing business plans.

The Company is also currently developing a variety of opportunities which would generate additional funds, including joint ventures, equity financings, licensing agreements and other financing activities.

In the unlikely event that the Company is unable to raise additional funds required to finance its operations, operating costs will have to be significantly reduced by decreasing spending on advertising and promotion activities, outside clinical programs and a variety of other discretionary external expenditures.

## INDEPENDENT AUDITORS' REPORT

THE BOARD OF DIRECTORS AND SHAREHOLDERS  
ADVANCED POLYMER SYSTEMS, INC.:

We have audited the accompanying consolidated balance sheets of Advanced Polymer Systems, Inc. and subsidiaries as of December 31, 1995 and 1994, and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 1995. In connection with our audits of the consolidated financial statements, we also have audited the financial statement schedule as listed in the accompanying index. These consolidated financial statements and the financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and the financial statement schedule based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Advanced Polymer Systems, Inc. and subsidiaries as of December 31, 1995 and 1994, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 1995, in conformity with generally accepted accounting principles. Also in our opinion, the related financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

KPMG PEAT MARWICK LLP

San Francisco, California  
March 15, 1996

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Within the twenty-four month period prior to December 31, 1995 and through the date of this report, there has not been a change in accountants or a reported disagreement with accountants on any matter of accounting principles or practices or financial statement disclosure.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

APS incorporates by reference the information set forth under the captions "Nomination and Election of Directors" and "Executive Compensation" of the Company's Proxy Statement (the "Proxy Statement") for the annual meeting of shareholders to be held on June 5, 1996.

ITEM 11. EXECUTIVE COMPENSATION

APS incorporates by reference the information set forth under the caption "Executive Compensation" of the Proxy Statement.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The Company incorporates by reference the information set forth under the caption "Beneficial Stock Ownership" of the Proxy Statement.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The Company incorporates by reference the information set forth under the caption "Certain Transactions" of the Proxy Statement.

## PART IV

## ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K

## (a) 1. Financial Statements

The financial statements and supplementary data set forth on pages 19-33 of Part II of the 10-K Annual Report are incorporated herein by reference.

## 2. Financial Statement Schedules

## Schedule II Valuation Accounts

All other schedules have been omitted because the information is not required or is not so material as to require submission of the schedule, or because the information is included in the financial statements or the notes thereto.

## 3. Exhibits

- 3-A -Copy of Registrant's Certificate of Incorporation. (1)
- 3-B -Copy of Registrant's Bylaws. (1)
- 10-B -Lease Agreement between the Registrant and White Properties Joint Venture for lease of Registrant's executive offices in Redwood City, dated as of August 1, 1992. (3)
- 10-C -Registrant's 1992 Stock Plan dated August 11, 1992. (2)\*
- 10-N -Agreement with Johnson & Johnson dated April 14, 1992. (3)
- 10-O -Unit Purchase Agreement dated June 6, 1994. (5)
- 10-P -Warrant to Purchase Common Stock. (5)
- 10-Q -Investment Agreement with Johnson & Johnson Development Corporation dated May 13, 1994. (5)
- 10-R -Form of Warrant to purchase Common Stock issued to Johnson & Johnson Development Corporation (5)
- 10-S -Lease Agreement between Registrant and Financing for Science International dated September 1, 1995 (6)
- 10-T -Security and Loan Agreement between Registrant and Venture Lending dated September 27, 1995 (6)
- 10-U -Asset Purchase Agreement with Dow Corning Corporation dated January 23, 1996.
- 21 -Proxy Statement for the Annual Meeting of Shareholders. (4)
- 23 -Consent of Independent Auditors.
- 27 -Financial Data Schedules

(b) Reports on Form 8-K  
None.(c) Exhibits  
The Company hereby files as part of this Form 10-K the exhibits listed in Item 14(a)3. As set forth above.(d) Financial Statement Schedules  
See Item 14(a)2. of this Form 10-K.

- 
- (1) Filed as an Exhibit with corresponding Exhibit No. to Registrant's Registration Statement on Form S-1 (Registration No. 33-15429) and incorporated herein by reference.
  - (2) Filed as Exhibit No. 28.1 to Registrant's Registration Statement on Form S-8 (Registration No. 33-50640), and incorporated herein by reference.
  - (3) Filed as an Exhibit with corresponding Exhibit No. to Registrant's Annual Report on Form 10-K for the year ended December 31, 1992, and incorporated herein by reference.
  - (4) To be filed supplementally.
  - (5) Filed as an Exhibit with corresponding Exhibits 4.1, 4.2, 4.3 and 4.4 to Registrant's Registration Statement on Form S-3 (Registration No. 33-82562) and incorporated herein by reference.
  - (6) Filed as an Exhibit with corresponding Exhibit No. to Registrant's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 1995.

\* Management Contract or Compensatory plans.

For purposes of complying with the amendments to the rules governing Registration Statements on Form S-8 (effective July 13, 1990) under the Securities Act of 1933 ("the Act"), as amended, the undersigned registrant hereby undertakes as follows, which undertaking shall be incorporated by reference into Part II of the registrant's Registration Statements on Form S-8 Nos. 33-18942, 33-21829, 33-29084 and 33-50640 filed on December 8, 1987, May 13, 1988, June 6, 1989 and August 11, 1992, respectively.

Insofar as indemnification for liabilities arising under the Securities Act of 1933 may be permitted to directors, officers and controlling persons of the registrant pursuant to the foregoing provisions, or otherwise, the registrant has been advised that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Act and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment by the registrant of expenses incurred or paid by a director, officer or controlling person of the registrant in the successful defense of any action, suit or proceeding) is asserted by such director, officer or controlling person in connection with the securities being registered, the registrant will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the Act and will be governed by the final adjudication of such issue.

## SIGNATURES

Pursuant to the requirement of Section 13 or 15 (d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

ADVANCED POLYMER SYSTEMS, INC.

By: /s/ John J. Meakem, Jr.

-----  
John J. Meakem, Jr.

Chairman, President, Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following person in the capacities and on the dates indicated.

Signature	Title	Date
-----	-----	-----
/s/ John J. Meakem, Jr. ----- John J. Meakem, Jr.	Chairman, President, Chief Executive Officer	March 27, 1996
/s/ Michael O'Connell ----- Michael O'Connell	Senior Vice President, Chief Administrative Officer and Chief Financial Officer	March 27, 1996
/s/ Carl Ehmann ----- Carl Ehmann	Director	March 27, 1996
/s/ Jorge Heller ----- Jorge Heller	Director	March 27, 1996
/s/ Helen C. Leong ----- Helen C. Leong	Director	March 27, 1996
/s/ Peter Riepenhausen ----- Peter Riepenhausen	Director	March 27, 1996
/s/ Toby Rosenblatt ----- Toby Rosenblatt	Director	March 27, 1996
/s/ Gregory H. Turnbull ----- Gregory H. Turnbull	Director	March 27, 1996
/s/ Dennis Winger ----- Dennis Winger	Director	March 27, 1996

## SCHEDULE II

## VALUATION ACCOUNTS

	Beginning Balance	Additions Charged to Expense	Deductions	Ending Balance
December 31, 1993 Accounts receivable, allowance for doubtful accounts	\$29,132	\$108,240	\$1,352	\$136,020
December 31, 1994 Accounts receivable, allowance for doubtful accounts	\$136,020	\$5,833	\$75,289	\$66,564
December 31, 1995 Accounts receivable, allowance for doubtful accounts	\$66,564	\$29,464	\$27,378	\$68,650

## CONSENT OF INDEPENDENT AUDITORS

THE BOARD OF DIRECTORS AND SHAREHOLDERS  
ADVANCED POLYMER SYSTEMS, INC.:

We consent to incorporation by reference in the Registration Statements (Nos. 33-18942, 33-21829, 33-29084 and 33-50640) on Forms S-8 of Advanced Polymer Systems, Inc. and in the Registration Statements (Nos. 33-47399, 33-51326 and 33-82562, 33-88972 and 333-759) on Forms S-3 of Advanced Polymer Systems, Inc. of our report dated March 15, 1996, relating to the consolidated balance sheets of Advanced Polymer Systems, Inc. and subsidiaries as of December 31, 1995 and 1994, the related consolidated statements of operations, shareholders' equity and cash flows for each of the years in the three year period ended December 31, 1995, and the related schedule, which report appears in the December 31, 1995 annual report on Form 10-K of Advanced Polymer Systems, Inc.

KPMG PEAT MARWICK LLP

San Francisco, California  
March 27, 1996

## EXHIBIT INDEX

## FORM 10-K ANNUAL REPORT

## ADVANCED POLYMER SYSTEMS, INC.

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- (6) Filed as an Exhibit with corresponding Exhibit No. to Registrant's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 1995.
- \* Management Contract or Compensatory plans.

## REGISTRATION RIGHTS AGREEMENT

January 23, 1996

Advanced Polymer Systems, Inc., a Delaware corporation ("APS") and Dow Corning Corporation, a Michigan corporation ("PURCHASER"), hereby agree as follows:

## RECITALS

A. APS is acquiring a polymer-based carrier system business from PURCHASER, and in payment thereof is issuing 200,000 shares of its Common Stock (the "Shares") to PURCHASER.

B. The parties wish to provide for the registration of the subsequent resale of the Shares and for the orderly distribution thereof, all on the terms and conditions hereof.

## THE PARTIES AGREE AS FOLLOWS:

## 1. Registration Rights; Listing.

1.1 Certain Definitions. As used herein, the following terms shall have the following respective meanings:

(a) "Commission" shall mean the Securities and Exchange Commission or any other federal agency at the time administering the Securities Act.

(b) "Convertible Securities" shall mean securities of APS convertible into or exchangeable for Registrable Securities.

(c) "Holder" shall mean any holder of outstanding Registrable Securities which have not been sold to the public, but only if such holder is PURCHASER or an assignee or transferee of Registration rights as permitted by Section 1.8.

(d) The terms "Registrar", "Registered" and "Registration" refer to a registration effected by preparing and filing a registration statement in compliance with the Securities Act ("Registration Statement"), and the declaration or ordering of the effectiveness of such Registration Statement.

(e) "Registrable Securities" shall mean the Shares issued to PURCHASER by APS, together with any Common Stock issued with respect to the Shares pursuant to stock splits, stock dividends and similar distributions, so long as such securities have not been sold to the public in a public distribution or a public securities transaction or sold in a single transaction exempt from the registration and prospectus delivery requirements of the Securities Act such that all transfer restrictions and restrictive legends with respect to such Shares shall have been removed in connection with such sale.

(f) "Registration Expenses" shall mean all expenses incurred by APS in complying with this Agreement, including, without limitation, all federal and state registration, qualification and filing fees, printing expenses, fees and disbursements of counsel for APS, blue sky fees and expenses, the expense of any special audits incident to or required by any such Registration and any expenses related to the maintenance of such Registration and qualification during the period specified in Section 1.4(a) hereof.

(g) "Securities Act" shall mean the Securities Act of 1933, as amended, or any similar federal statute, and the

rules and regulations of the Commission thereunder, all as the same shall be in effect at the time.

(h) "Selling Expenses" shall mean all underwriting discounts and selling commissions applicable to the sale of Registrable Securities pursuant to this Agreement.

#### 1.2 Registration.

1.2.1 Registration. Subject to the terms of this Agreement, APS shall use its best efforts to effect Registration of the Registrable Securities within 60 days of their issuance to PURCHASER by filing as soon as possible after the date hereof a Form S-3 Registration Statement (or any successor to Form S-3) with the Commission.

1.2.2 Registration of Other Securities. Any Registration Statement filed under this Section 1 may include securities of APS other than Registrable Securities; provided, however, that neither PURCHASER or any Holder shall be required to utilize an underwriter in connection with the sale of their Registrable Securities.

1.2.3 Blue Sky. In the event of any Registration pursuant to Section 1, APS will exercise its best efforts to Register and qualify the securities covered by the Registration Statement under such other securities or Blue Sky laws of such jurisdictions as shall be reasonably appropriate for the distribution of such securities; provided, however, that:

(a) APS shall not be required to qualify to do business or to file a general consent to service of process in

any such states or jurisdictions, unless APS is already subject to service in such jurisdiction; and

(b) notwithstanding anything in this Agreement to the contrary, in the event any jurisdiction in which the securities shall be qualified imposes a non-waivable requirement that expenses incurred in connection with the qualification of the securities be borne by selling shareholders, such expenses shall be payable pro rata by selling shareholders.

1.3 Expenses of Registration. All Registration Expenses (but not Selling Expenses) incurred in connection with the Registration pursuant to Section 1 shall be borne by APS.

1.4 Registration Procedures. Whenever required under this Agreement to effect the Registration of any securities of APS, subject to the other provisions of this Agreement, APS shall, as expeditiously as reasonably possible:

(a) Prepare and file with the Commission a Registration Statement with respect to such securities in accordance with Section 1.2.1 and use its diligent best efforts to cause such Registration Statement to become effective as promptly as possible thereafter and to remain effective for a period equal to the shorter of: (i) three years from the date of such effectiveness; or (ii) until the distribution described in the Registration Statement has been completed.

(b) Prepare and file with the Commission such amendments and supplements to such Registration Statement and the prospectus used in connection with such Registration Statement as may be necessary to comply with the provisions of the Securities

Act with respect to the disposition of all securities covered by such Registration Statement.

(c) Furnish to the Holders participating in such Registration and the underwriters, if any, of the securities being Registered, such reasonable number of copies of the Registration Statement, preliminary prospectus and final prospectus as they may request in order to facilitate the public offering of such securities.

1.5 Additional Information Available. So long as the Registration Statement is effective covering the resale of Shares owned by a Holder, APS will furnish to the Holder(s):

(a) as soon as practicable after it becomes available (but in the case of APS' Annual Report to Stockholders, within 120 days after the end of each fiscal year of APS), one copy of: (i) its Annual Report to Stockholders (which Annual Report shall contain financial statements audited in accordance with generally accepted accounting principles by a national firm of certified public accountants); (ii) if not included in substance in the Annual Report to Stockholders, its Annual Report on Form 10-K; (iii) if not included in substance in its Quarterly Reports to Stockholders, its quarterly reports on Form 10-Q; and (iv) a full copy of the particular Registration Statement covering the Shares (the foregoing, in each case, excluding exhibits); and

(b) upon the reasonable request of a Holder, all exhibits excluded by the parenthetical to subparagraph (a) (iv) of this Section 1.5;

and APS, upon the reasonable request of a Holder, will meet with such Holder or a representative thereof at APS' headquarters to discuss all information relevant for disclosure in the Registration Statement covering the Shares and will otherwise cooperate with any Holder conducting an investigation for the purpose of reducing or eliminating such Holder's exposure to liability under the Securities Act, including the reasonable production of information at APS' headquarters.

1.6 Information Furnished by Holder. It shall be a condition precedent of APS' obligations under this Agreement that each Holder of Registrable Securities included in any Registration furnish to APS such information regarding such Holder and the distribution proposed by such Holder as APS may reasonably request.

1.7 Indemnification.

1.7.1 Company's Indemnification of Holder. APS will indemnify and hold harmless each Holder, each of its officers, directors, employees, agents, affiliates and constituent partners, and each person deemed to be in control of such Holder within the meaning of Section 15 of the Securities Act or Section 20 of the Securities Exchange Act of 1934 (the "Exchange Act"), from and against all claims, losses, damages or liabilities (or actions in respect thereof) to the extent such claims, losses, damages or liabilities arise out of or are based upon any untrue statement (or alleged untrue statement) of a material fact contained in any prospectus or other document (including any related Registration Statement) incident to any

such Registration, qualification or compliance, or are based on any omission (or alleged omission) to state therein a material fact required to be stated therein or necessary to make the statements therein not misleading, or any violation by APS of any rule or regulation promulgated under the Securities Act applicable to APS and relating to action or inaction required of APS in connection with any such Registration, qualification or compliance or arise out of any failure by APS to fulfill an undertaking included in the Registration Statement; and APS will reimburse each such Holder, each such underwriter and each person who controls any such Holder or underwriter, for any legal and any other expenses reasonably incurred in connection with defending any such claim, loss, damage, liability or action; provided, however, that the indemnity contained in this Section 1.7.1 shall not apply to amounts paid in settlement of any such claim, loss, damage, liability or action if settlement is effected without the consent of APS (which consent shall not unreasonably be withheld) and; provided, further, that APS will not be liable in any such case to the extent that any such claim, loss, damage, liability or expense arises out of or is based upon any untrue statement or omission based upon written information furnished to APS by such Holder or controlling person and stated expressly to be for use in connection with the offering of securities of APS.

1.7.2 Holder's Indemnification of Company. Each Holder will indemnify and hold harmless APS, each of its directors, officers, employees, agents and affiliates, each

person deemed to be in control of APS within the meaning of Section 15 the Securities Act or Section 20 of the Exchange Act, and each other such Holder, each of its officers, directors, employees, agents, affiliates and constituent partners, and each person deemed to be in control of such other Holder within the meaning of Section 15 of the Securities Act or Section 20 of the Exchange Act, from and against all claims, losses, damages and liabilities (or actions in respect thereof) arising out of or based upon any untrue statement (or alleged untrue statement) of a material fact contained in any such Registration Statement, prospectus, offering circular or other document, or any omission (or alleged omission) to state therein a material fact required to be stated therein or necessary to make the statements therein not misleading, or any violation by such Holder of any rule or regulation promulgated under the Securities Act applicable to such Holder and relating to action or inaction required of such Holder in connection with any such Registration, qualification or compliance; and will reimburse APS, such Holder, such directors, officers, partners, persons or control persons for any legal and any other expenses reasonably incurred in connection with defending any such claim, loss, damage, liability or action, in each case to the extent, but only to the extent, that such untrue statement (or alleged untrue statement) or omission (or alleged omission) is made in such Registration Statement, prospectus, offering circular or other document in reliance upon and in conformity with written information furnished to APS by such Holder and specifically approved in writing by such Holder for

use in connection with the offering of securities of APS; provided, however, that the indemnity contained in this Section 1.7.2 shall not apply with respect to a Holder to amounts paid in settlement of any claim, loss, damage, liability or action if settlement is effected without the consent of such Holder (which consent shall not be unreasonably delayed or withheld).

1.7.3 Indemnification Procedure. Promptly after receipt by an indemnified party under this Section 1.7 of notice of the commencement of any action, such indemnified party will, if a claim in respect thereof is to be made against an indemnifying party under this Section 1.7, notify the indemnifying party in writing of the commencement thereof and, to the extent reasonably possible, generally summarize such action. The indemnifying party shall have the right to participate in and to assume the defense of such claim; provided, however, that the indemnifying party shall be entitled to select counsel for the defense of such claim with the approval of any parties entitled to indemnification, which approval shall not be unreasonably withheld; provided, further, that if either party reasonably determines that there may be a conflict between the position of APS and a Holder in conducting the defense of such action, suit or proceeding by reason of recognized claims for indemnity under this Section 1.7, then counsel for such party shall be entitled to conduct, or participate in, the defense to the extent reasonably determined by such counsel to be necessary to protect the interest of such party and the costs of such counsel shall be borne by the indemnifying party. The failure to notify an

indemnifying party promptly of the commencement of any such action, if prejudicial to the ability of the indemnifying party to defend such action, shall relieve such indemnifying party, to the extent so prejudiced, of any liability to the indemnified party under this Section 1.7, but the omission so to notify the indemnifying party will not relieve such party of any liability that such party may have to any indemnified party otherwise other than under this Section 1.7.

1.8 Transfer of Rights. The right to cause APS to Register securities granted by APS to PURCHASER under this Agreement may be assigned by any Holder to a transferee or assignee of any Registrable Securities not sold to the public acquiring at least 25,000 shares of such Holder's Registrable Securities (equitably adjusted for any stock splits, subdivisions, stock dividends, changes, combinations or the like); provided, however, that:

(a) APS must receive written notice prior to the time of said transfer, stating the name and address of said transferee or assignee and identifying the securities with respect to which such information and Registration rights are being assigned; and

(b) the transferee or assignee of such rights must not be a person deemed by the Board of Directors of APS, in its best judgment, to be a competitor or potential competitor of APS. Notwithstanding the limitations set forth in the foregoing sentence respecting the minimum number of shares which must be transferred and permitted transferees and assignees: (i) any

Holder which is a partnership may transfer such Holder's Registration rights to such Holder's constituent partners without restriction as to the number or percentage of shares acquired by any such constituent partner; and (ii) Section 1.8(b) shall not prohibit the transfer or assignment of such rights to an affiliate of the PURCHASER.

1.9 Nasdaq Listing. Prior to the effective date of a Registration of any of the Shares, APS shall file an application with NASDAQ to list such Shares for quotation on the Nasdaq National Market.

1.10 Delay in Effectiveness. In the event a Registration Statement covering the Shares is not declared effective within ninety (90) days after the date hereof or in the event the effectiveness of such Registration Statement is suspended or terminated at any time subsequent to the 90th day after the date hereof and prior to the termination of the period specified in Section 1.4(a) hereof, APS shall pay to the Holders an amount equal to \$275 per day for each day such Registration Statement is not effective; provided that nothing herein is intended to limit a Holder's ability to seek to enforce its rights to require that a Registration Statement covering Shares remains effective during the period specified in Section 1.4 hereof; and provided further that APS shall not be required to make any payments to a Holder if the failure to obtain or maintain an effective Registration Statement is solely attributable to a Holder's failure to provide APS with

information required to be provided by such Holder for inclusion in the Registration Statement.

2. Miscellaneous.

2.1 Governing Law. This Agreement shall be governed by and construed in accordance with the laws of the State of California applicable to contracts entered into and wholly to be performed within the State of California by California residents.

2.2 Successors and Assigns. Subject to the exceptions specifically set forth in this Agreement, the terms and conditions of this Agreement shall inure to the benefit of and be binding upon the respective executors, administrators, heirs, successors and assigns of the parties.

2.3 Entire Agreement. This Agreement and the Asset Purchase Agreement and the Exhibits and Schedules hereto and thereto constitute the entire contract between APS and the PURCHASER relative to the subject matter hereof. Any previous agreement between APS and the PURCHASER with respect to the subject matter hereof is superseded by this Agreement.

2.4 Severability. Any invalidity, illegality or limitation of the enforceability with respect to any Holder of any one or more of the provisions of this Agreement, or any part thereof, whether arising by reason of the law of any PURCHASER's domicile or otherwise, shall in no way affect or impair the validity, legality or enforceability of this Agreement with respect to other Holders. In case any provision of this Agreement shall be invalid, illegal or unenforceable, it shall to the extent practicable, be modified so as to make it valid, legal

and enforceable and to retain as nearly as practicable the intent of the parties, and the validity, legality and enforceability of the remaining provisions shall not in any way be affected or impaired thereby.

2.5 Amendment of Agreement. Any provision of this Agreement may be amended only by a written instrument signed by APS and by PURCHASER.

2.6 Notices. Any notice required or permitted hereunder shall be given in writing and shall be conclusively deemed effectively given upon personal delivery, or five days after deposit in the United States mail, by registered or certified mail, postage prepaid, addressed:

(a) if to APS, Advanced Polymer Systems, Inc., 3696 Haven Avenue, Redwood City, California 94063, ATTENTION: President; and

(b) if to PURCHASER, Dow Corning Corporation, 2200 W. Salzburg Road, Midland, Michigan 48686-0994, ATTENTION: General Counsel.

2.7 Headings. The headings of the Sections of this Agreement are for convenience and shall not by themselves determine the interpretation of this Agreement.

2.8 Counterparts. This Agreement may be executed in two or more counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument.

IT WITNESS WHEREOF, the parties have executed this Agreement.

ADVANCED POLYMER SYSTEMS, INC.

By: /s/ Michael O'Connell

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Michael O'Connell  
Senior Vice President and CFO

DOW CORNING CORPORATION

By: /s/ William P. Cavanaugh

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William P. Cavanaugh  
Commercial Unit Manager  
Personal Household and  
Automotive Products

## ASSET PURCHASE AGREEMENT

THIS AGREEMENT made the 23rd day of January, 1996, by and between ADVANCED POLYMER SYSTEMS, INC., a Delaware corporation with its principal place of business at 3696 Haven Avenue, Redwood City, California 94063 ("APS") and DOW CORNING CORPORATION, a Michigan corporation with its principal place of business at 2200 W. Salzburg Road, Midland, Michigan 48686-0994 ("DCC").

## RECITALS

A. APS and DCC entered into a Joint Agreement effective November 25, 1991, providing for joint cross licensing, joint development and sharing of gross margin from the marketing of certain Microsponge(R) Systems and Polytrap(R) Systems (together, the "Systems").

B. APS and DCC entered into a Purchase/Sales Agreement effective November 25, 1991, providing for supply of the Systems by APS to DCC and their purchase by DCC from APS.

C. The parties now desire to terminate the Joint Agreement and the Purchase/Sales Agreement.

D. The parties also now desire to provide for the sale, transfer and assignment by DCC to APS of certain worldwide patents that cover the Polytrap(R) System, all unpatented Polytrap(R) Technology and the Polytrap(R) Trademarks on the terms and conditions and for the consideration herein set forth.

IT IS, THEREFORE, AGREED as follows:

1. Definitions. For the purposes of this Agreement, the following definitions shall apply.

"Affiliates" of a party shall mean agents, representatives, attorneys, successors, assigns, employees, officers, directors and shareholders of, or entities controlling, controlled by or under common control with, the party.

"Capital Loan" shall have the definition as set forth in Section 7.1 of the Joint Agreement.

"Closing Date" shall have the meaning as defined in Section 3 hereto.

"Division of Gross Margin" shall have the meaning consistent with Section 6 of the Joint Agreement and the definition of "Gross Margin" in such agreement.

"Joint Agreement" shall mean the agreement between the parties effective November 25, 1991, a copy of which is attached hereto as Exhibit A.

"Microsponge(R) System" shall mean a polymer-based delivery system as described and claimed in U.S. Patent No. 4,690,825.

"Net Sales" shall have the meaning set forth in Section 1.11 of the Joint Agreement.

"Purchase/Sales Agreement" shall mean the Purchase/Sales Agreement effective November 25, 1991 between the parties.

"Polytrap(R) System Assets" shall have the meaning as set forth in Section 3.1.

"Polytrap(R) System" shall mean a polymer-based carrier system as described and claimed in U.S. Patent No. Re. 33,429 issued on November 6, 1990.

"Polytrap(R) Patents" shall mean the patents and patent applications as listed on Exhibit B, and any patents that may issue on such patent applications, any divisions, continuations, continuations-in-part and reissues and renewals thereof, and all foreign counterparts thereof.

"Polytrap(R) Patents" shall not include (a) U.S. patent number 5,100,477 and 5,126,309, and Japanese application number 121430/9, all of which are entitled "Decontamination of Toxic Chemical Agents"; and (b) U.S. patent number 5,173,520 entitled "Colorant Material with a Polymerized Coating," which are not listed on Exhibit B.

"Polytrap(R) Technology" shall mean know-how, trade secrets, inventions, data, technology and information, including, but not limited to, improvements thereof, relating to a Polytrap(R) System which are now owned by DCC and which DCC has the lawful right to disclose. Polytrap(R) Technology shall include, but shall not be limited to, processes and analytical methodology used in development, testing, analysis and manufacture, and clinical, toxicological, research, formulation, product development and other scientific data.

"Polytrap(R) Trademarks" shall mean the marks "Polytrap(R)", "Polytrap FLM(R)" and "Polytrap SMP(R)" in use by or registered to DCC.

"Related Seller Documents" shall have the meaning as set forth in Section 6.1(b) hereof.

"Related Purchaser Documents" shall have the meaning as set forth in Section 6.2(b) hereof.

"System(s)" shall mean a Microsponge(R) and/or Polytrap(R) System.

2. Termination of Existing Agreements.

2.1 The Joint Agreement shall be terminated effective on the Closing Date, as defined in Section 7. Notwithstanding such termination, DCC shall pay to APS the excess of APS' unpaid share of the Division of Gross Margin over the balance that may be due to DCC on the Capital Loan (subject to paragraph 2.3 of this Section) and the Capital Loan shall be considered paid in full.

2.2 The Purchase/Sales Agreement shall be terminated as of the Closing Date. Notwithstanding such termination, DCC shall make payment of all outstanding unpaid bills for purchases from APS (subject to provision 2.3 of this Section).

2.3 Any monies due APS, which relate to purchases and sales occurring prior to DCC's filing on May 15, 1995 for Chapter 11 protection under the U.S. Bankruptcy Code and still unpaid at Closing Date, may be considered pre-petition claims of APS against DCC and subject to payment in accordance with and upon confirmation of DCC's plan of reorganization.

3. Sale of Polytrap(R) System Assets.

3.1 DCC agrees to sell to APS and APS agrees to buy from DCC full right and title to the Polytrap(R) Patents, the Polytrap(R) Technology, the Polytrap(R) Trademarks, and all customer information and files with respect to the sale of products utilizing the Polytrap(R) Patents or Technology (collectively, the "Polytrap(R) System Assets"). In consideration of such sale by DCC, APS shall issue to DCC 200,000 shares of its common stock (the "Shares"). The Shares shall be publicly marketable (subject to any applicable securities law restriction or limitation) pursuant to a separate agreement to be executed substantially in the form attached as Exhibit C ("Registration Rights Agreement").

3.2 The Closing of the sale and transfer contemplated by this Agreement (the "Closing") shall take place in Chicago on or before March 31, 1996, or at such other place, time and date as shall be fixed by mutual agreement between the parties hereto. The date of Closing is referred to herein as the "Closing Date".

3.3 The sale, assignment, conveyance, transfer and delivery of the Polytrap(R) Assets shall be made at the Closing by appropriate bills of sale, assignments, endorsements and such other appropriate instruments of transfer, all in form and substance satisfactory to APS, as shall be sufficient to vest in APS as of the Closing Date good and merchantable title to the Polytrap(R) System Assets free and clear of any liens, charges, options, encumbrances or adverse claims of any kind. Such instruments of assignment, conveyance and transfer shall include the Patent Assignment and Trademark Assignment, substantially in the form set forth hereto as Exhibits D and E, respectively.

3.4 APS shall be responsible for preparing and recording documents, including payment of any fees and expenses related thereto, as may be required for affecting transfer of title and interest in, to and under all of the Polytrap(R) System Assets from DCC to APS.

3.5 DCC agrees that at the Closing and from time to time thereafter, without additional consideration, it will execute and deliver or cause to be executed and delivered such other and further instruments of assignment, transfer or conveyance of any of the assets and properties being transferred and conveyed herein and take such other action as APS may reasonably request to effect the transfer to APS of the right, title and interest in, to and under all of the Polytrap(R) System Assets.

4. Distribution Agreement. In order to assist with the business transition from DCC to APS, DCC shall continue to distribute and sell on behalf of APS all products that have been covered by the Joint Agreement between the parties for a period not to exceed one (1) year in exchange for a service fee paid to DCC by APS of three (3%) percent of Net Sales of such products made directly by DCC's sales force. The terms and conditions of such sales and distribution arrangement shall be as set forth in a separate agreement substantially in the form attached hereto as Exhibit F ("Distribution Agreement").

5. Noncompete. In consideration of the undertakings herein by APS, DCC agrees that it will not compete with APS for a period of ten years from the December 31, 1995, in the United States and other parts of the world where Systems are presently being sold or utilized in products, in the business of creating, licensing or marketing polymer-based carrier systems, pursuant to a separate agreement to be executed substantially in the form attached as Exhibit G ("Non-Compete Agreement").

6. Representations and Warranties.

6.1 DCC represents and warrants:

(a) DCC is a corporation duly organized, validly existing and in good standing under the laws of the State of Michigan and has the corporate power to own, lease and operate its properties and to carry on its business as now being conducted. There will be delivered to APS on the Closing Date accurate and complete copies of the Restated Articles of Incorporation and Bylaws of DCC in effect on the Closing Date.

(b) DCC has all necessary corporate power and authority under its Restated Articles of Incorporation and Bylaws and under the laws of the State of Michigan and

other applicable laws to execute, deliver and perform this Agreement and any other agreements or documents delivered pursuant to this Agreement (the "Related Seller Documents"). The execution, delivery and performance of this Agreement and the Related Seller Documents have been duly authorized by all necessary corporate action on the part of DCC, including any shareholder and director approval necessary for the consummation of the transactions hereby contemplated. This Agreement is, and each of the Related Seller Documents when executed and delivered by DCC will be, a valid, binding and enforceable obligation of DCC.

(c) DCC is not a party to any agreement, written or oral, that is inconsistent with this Agreement.

(d) Except as set forth on Exhibit B hereto, to its knowledge, (i) DCC has full right, title and interest in the Polytrap(R) Patents, the Polytrap(R) Technology and the Polytrap(R) Trademarks and; (ii) DCC is not presently aware of any patents owned by a third party which would be infringed by the practice of the Polytrap(R) Patents or the Polytrap(R) Technology.

(e) Except as set forth on Exhibit B hereto, to the knowledge of DCC there have been no customer complaints concerning the use of any product that utilizes Polytrap(R) Patents or Polytrap(R) Technology during the period of two years prior to the Closing Date.

#### 6.2 APS represents and warrants:

(a) APS is a corporation duly organized, validly existing and in good standing under the laws of the State of Delaware and has the corporate power to own, lease and operate its properties and to carry on its business as now being conducted. There will be delivered to DCC on the Closing Date accurate and complete copies of the Certificate of

Incorporation and Bylaws of APS in effect on the Closing Date.

(b) APS has all necessary corporate power and authority under its Certificate of Incorporation and Bylaws and under the laws of the State of Delaware and other applicable laws to execute, deliver and perform this Agreement and any other agreements or documents delivered pursuant to this Agreement (the "Related Purchaser Documents"). The execution, delivery and performance of this Agreement and the Related Purchaser Documents have been duly authorized by all necessary corporate action on the part of APS, including any shareholder and director approval necessary for the consummation of the transactions hereby contemplated. This Agreement is, and each of the Related Purchaser Documents when executed and delivered by APS will be, a valid, binding and enforceable obligation of APS.

(c) APS is not a party to any agreement, written or oral, that is inconsistent with this Agreement.

(d) The Shares have been duly and validly issued and are fully paid and non-assessable. No pre-emptive right, co-sale right, registration right, right of first refusal or other similar right exists with respect to the Shares or as a result of the issuance and sale thereof. No further approval or authorization of any shareholder or director of APS or of any other party is required for the issuance and sale or transfer of the Shares in accordance with the terms of this Agreement and the Registration Rights Agreement.

7. Conditions of Closing; Closing Deliveries.

7.1 The obligations of APS to close under this Agreement are subject to the satisfaction of all of the following conditions as of the Closing Date, any of which may be waived by APS:

(a) the representations and warranties of DCC set forth in this Agreement or in any certificate or document called for in this Agreement shall be true and correct in all material respects as made, both on the date hereof and at and as of the Closing (as though such representations and warranties were made anew), and, except with respect to the effect of transactions permitted by the provisions of this Agreement, all agreements and transactions contemplated hereby and to be performed by DCC on or before the Closing shall have been duly performed.

(b) there shall have been delivered to APS by DCC such bills of sale, assignments, and other good and sufficient instruments of transfer (the "Transfer Documents"), including, without limitation, the Patent Assignment and Trademark Assignment, conveying and transferring to APS title to the Polytrap(R) Patents and Trademarks as provided in this Agreement, and all other required documents, certificates, and instruments set forth in Section 7.3. Provided, however, to the extent that it is not practicable to deliver any of such conveyancing documents other than the Patent Assignment and the Trademark Assignment at the time of Closing, such documents shall be delivered to APS as soon as practicable thereafter.

7.2 The obligations of DCC to close under this Agreement are subject to the satisfaction of all of the following conditions as of the Closing Date, any of which may be waived by DCC:

(a) the representations and warranties of APS contained in this Agreement or in any certificate or document called for in this Agreement shall be true and correct in all material respects as made, both on the date hereof and at and as of the Closing (as though such representations and warranties were made anew), and, except with respect to the effect of transactions permitted by the provisions of this Agreement, all agreements and transactions contemplated hereby and to be performed by APS on or before the Closing shall have been duly performed.

(b) there shall have been delivered to DCC a certified copy of a Resolution of the Board of Directors of APS authorizing and approving the purchase of the Polytrap(R) System Assets.

(c) DCC shall have obtained approval from the U.S. Bankruptcy Court, Eastern District of Michigan, Northern Division to enter into the transactions contemplated by this Agreement.

7.3 At the Closing, DCC shall tender or cause to be tendered to APS the following:

(a) the Transfer Documents referred to in Section 7.1(b) hereof properly executed and acknowledged.

(b) appropriate receipts.

(c) all other documents and papers required by Section 7.1 hereof as conditions of Closing and executed counterparts of the Agreements attached hereto as exhibits including:

- (1) the Patent Assignment, duly executed by DCC.
- (2) the Trademark Assignment, duly executed by DCC.
- (3) a counterpart of the Distribution Agreement, duly executed by DCC.
- (4) a counterpart of the Non-Compete Agreement, duly executed by DCC.
- (5) a counterpart of the Registration Rights Agreement, duly executed by DCC.

7.4 At the Closing, APS shall deliver to DCC the following:

(a) A certificate(s) for the Shares, free and clear of any and all encumbrances (other than any restrictions under the U.S. or state securities laws), in form satisfactory to DCC.

(b) all other documents and papers required by Section 7.2 hereof as conditions to the Closing and executed counterparts of the Agreements attached hereto as exhibits, including:

- (1) a counterpart of the Distribution Agreement, duly executed by APS.
- (2) a counterpart of the Non-Compete Agreement, duly executed by APS.
- (3) a counterpart of the Registration Rights Agreement, duly executed by APS.

8. Disclaimer. APS agrees that, as of Closing Date, determination of the suitability of the Polytrap(R) System Assets for uses contemplated by APS will be the sole responsibility of APS, that DCC has not and does not represent that the Polytrap(R) System is suitable for, or has been tested for medical device, pharmaceutical, or any other medical product applications or end-uses, and that DCC shall not be held liable for the damages, direct or consequential, resulting from the use of the Polytrap(R) System Assets transferred to APS under this Agreement.

9. Assumption of Liabilities. APS shall assume, effective as of the Closing Date, and thereafter pay, perform and discharge all liabilities and obligations with respect to the prosecution, maintenance and protection of the Polytrap(R) System Assets, and all liabilities for the sale and delivery of Polytrap(R) System and Microsponge(R) System products after the Closing, including without limitation, tort liability, products liability, and strict liability related to Polytrap(R) System or Microsponge(R) System products made by APS after the Closing.

10. Indemnification.

10.1 The representations and warranties made in this Agreement by either party hereto and in any agreement, certificate, exhibit or document delivered in connection therewith shall survive the Closing.

10.2 DCC agrees to indemnify and hold harmless APS and its Affiliates from and against any loss, damage or expense (including reasonable attorneys' fees) suffered by APS resulting from (a) any material breach by DCC of this Agreement; (b) any material inaccuracy in or material breach of any of the representations, warranties or covenants made by DCC herein, or in any other agreement, or certificate delivered by DCC at the Closing in accordance with the provisions of any Section hereof; (c) any and all liabilities, obligations, charges, claims

and demands in any way relating to, arising out of, or connected with (i) the development, sale or distribution by DCC, or on behalf of DCC other than by APS, of the Polytrap(R) System product prior to the Closing, including, but not limited to, any products liability claims with respect to the Polytrap(R) System product manufactured by or on behalf of DCC, (ii) the conduct of the Polytrap(R) business prior to the Closing, or (iii) the ownership, possession or use of the Polytrap(R) System Assets prior to the Closing; and (d) the failure of DCC to pay, discharge or perform any liability or obligations of DCC which is not expressly assumed by APS under this Agreement.

10.3 APS agrees to indemnify and hold harmless DCC and its Affiliates from and against any loss, damage or expense (including reasonable attorneys' fees) suffered by DCC resulting from (a) any material breach by APS of this Agreement; (b) any material inaccuracy in or material breach of any of the representations, warranties or covenants made by APS herein, or in any agreement or certificate delivered by APS at the Closing in accordance with the provisions of any Section hereof; (c) any and all liabilities, obligations, charges, claims and demands in any way relating to, arising out of, or connected with (i) the development, manufacture, sale or distribution by APS, or on behalf of APS other than by DCC, of the Polytrap(R) System product after the Closing, including, but not limited to any products liability claims with respect to the Polytrap(R) System product manufactured by APS, (ii) the conduct of the Polytrap(R) business after the Closing, or (iii) the ownership, possession or use of the Polytrap(R) System Assets after the Closing; and (d) the failure of APS to pay, discharge or perform any liability or obligations of APS which is expressly assumed by APS under this Agreement.

10.4 (a) A party entitled to be indemnified pursuant to Section 10.2 or 10.3 hereof (the "Indemnified Party") shall notify the party liable for such indemnification (the "Indemnifying Party") in writing of any claim or demand which the Indemnified Party has determined has given or could give rise to a right of indemnification under this Agreement. Subject to the Indemnifying Party's right to defend in good faith third party claims as hereinafter provided, the Indemnifying Party shall satisfy its obligations under this Section within thirty (30) days after receipt of written notice thereof from the Indemnified Party.

(b) If the Indemnified Party shall notify the Indemnifying Party of any claim or demand pursuant to Section 10.4(a) hereof, and if such claim or demand relates to a claim or demand asserted by a third party against the Indemnified Party which the Indemnifying party acknowledges is a claim or demand for which it must indemnify or hold harmless the Indemnified Party under Section 10.2 or 10.3 hereof, the Indemnifying Party shall have the right to employ counsel acceptable to the Indemnified Party to defend any such claim or demand asserted against the Indemnified Party. The Indemnified Party shall have the right to cooperate in the defense of any such claim or demand. The Indemnifying Party shall notify the Indemnified Party in writing, within thirty (30) days after the date of the notice of claim given by the Indemnified Party to the Indemnifying Party under Section 10.4(a) hereof of its election to defend in good faith any such third party claim or demand. So long as the Indemnifying Party is defending in good faith any such claim or demand asserted by a third party against the Indemnified Party, the Indemnified Party shall not settle or compromise such claim or demand. The Indemnified Party shall make available other materials in the Indemnified Party's possession reasonably required by it for its use in contesting any third party claim or demand. Whether

or not the Indemnifying Party elects to defend any such claim or demand, the Indemnified Party shall have no obligation to do so.

10.5 The rights provided in this Section 10 do not constitute an election of remedies or waiver of any rights which may be available to any party other than as provided herein should the provisions of this Section 10 be found by a court of competent jurisdiction to be unenforceable, void or unavailable for any reason.

11. Confidentiality.

11.1 APS and DCC acknowledge that they will each become privy to confidential information relating to each such party's businesses during the course of the negotiations and during the period between the execution hereof and the Closing hereunder which it otherwise would not have known and that any disclosure of said information could injure such party's businesses. Therefore APS and DCC and their respective representatives, agents and employees agree to exert their best efforts (equivalent to the protection given their own confidential information) to prevent delivery or disclosure of all information so obtained to any third party or to any other outside source or used for any purpose other than the consummation of this Agreement. "Confidential Information" includes information ordinarily known only to the personnel of APS and DCC and includes, without limitation, customer lists, supplier lists, trade secrets, distribution channels, pricing policy and records, inventory records, and such other information designated as proprietary or confidential by APS or DCC.

11.2 It is understood and agreed by the parties that the above obligations to keep information confidential shall not attach to information which (a) was in the public knowledge or domain at the time of disclosure, (b) was known to the recipient prior to the time of receipt

under this Agreement as is shown by recipient's written or other tangible records, or (c) is obtained by the recipient from a third party who has a bona fide right to disclose the information and without obligations to keep it confidential. It is further understood and agreed by the parties that the obligations of confidence shall immediately cease at such time as the information becomes a part of the public knowledge or domain without breach or fault on the part of the receiving party, or a period of fifteen (15) years has lapsed from the date of this Agreement.

11.3 In the event that the recipient of such information considers certain confidential information received under this Agreement to be excluded from the above obligations of confidence and intends to disclose or transfer it to a third party, the recipient agrees to give the originating party thirty (30) days written notice prior to any such disclosure or transfer as to what information is believed to be excluded and the basis for the exclusion.

11.4 Further, neither party hereto shall make any public disclosure pertaining to the terms of this Agreement or any of the transactions contemplated hereby, unless such disclosure is necessary (a) to satisfy such party's legal or contractual obligations without the express written consent of the other party or (b) reasonably required for compliance with any federal or state securities laws, regulations, or filing requirements.

## 12. Miscellaneous.

12.1 The parties acknowledge that neither DCC, APS nor any party acting on behalf of DCC or APS has paid or become obligated to pay any fee or commission to any broker, finder or intermediary for or on account of the transactions contemplated by this Agreement.

12.2 APS shall be responsible for obtaining all licenses, permits and approvals

from public authorities necessary for it to use the Polytrap(R) System Assets, and DCC shall not be responsible for transferring or obtaining such licenses, permits or approvals, except that DCC shall cooperate with APS in attempting to obtain such licenses, permits and approvals.

12.3 Whether or not the transactions contemplated herein are consummated, unless otherwise expressly provided herein each party hereto shall pay its own expenses incident to this Agreement and the transactions contemplated herein, including all legal and accounting fees and disbursements. APS shall pay all sales and use taxes applicable to the transactions referred to in this Agreement. The party responsible under applicable law shall bear and pay in their entirety all other taxes and registration and transfer fees, if any, payable by reason of the sale and conveyance of the Polytrap(R) System Assets. The parties shall fully cooperate to avoid, to the extent legally possible, the payment of duplicate taxes, and each party shall furnish, at the request of the other, proof of payment of any taxes or other documentation which is a prerequisite to avoiding payment of a duplicate tax. Each party will cooperate to the extent practicable in minimizing all taxes and fees levied by reason of the sale and conveyance of the Polytrap(R) System Assets.

12.4 Neither of the parties hereto shall, prior to the Closing, issue or authorize to be issued any press release, or other public announcement concerning this Agreement or any of the transactions contemplated hereby (other than any filing required to be made by APS or DCC pursuant to any federal or state law or regulation), unless such release or announcement, in respect of timing and contents, has been approved by authorized executives or officers of both APS and DCC, as appropriate, which approval shall not be unreasonably withheld. Notwithstanding the foregoing, neither party is prevented from making such public

announcements as such party may consider necessary in order to satisfy such party's legal or contractual obligations, including, but not limited to, the public disclosure necessary for DCC to obtain Bankruptcy Court approval pursuant to Section 7.2(c) of this Agreement.

12.5 Legal title, equitable title and risk of loss with respect to the Polytrap(R) System Assets shall not pass to APS until they are transferred at the Closing hereunder.

12.6 All notices, requests, demands and other communications required or permitted hereunder shall be in writing and shall be deemed to be duly given upon delivery, if delivered by hand, or three business days after mailing, if mailed certified or registered first class mail, postage prepaid, properly addressed to the party entitled to receive such notice at the addresses stated below:

If to APS:                   Advanced Polymer Systems, Inc.  
                                  3696 Haven Avenue  
                                  Redwood City, California 94063  
Attention:                 President

If to DCC:                   Dow Corning Corporation  
                                  2200 W. Salzburg Road  
                                  Midland, Michigan 48686-0994  
Attention:                 General Counsel

or to such other address as a party may direct by notice given to the other party.

12.7 The parties have in this Agreement and the Exhibits hereto incorporated all representations, warranties, covenants, commitments and understandings on which they have relied in entering into this Agreement and, except as provided for herein, neither party has made any other covenant or commitment to the other concerning its future action. Accordingly, this Agreement, the Registration Rights Agreement, the Distribution Agreement, and the Non-

Compete Agreement (i) constitute the entire agreement and understanding between the parties with respect to the matters contained herein, and there are no promises, representations, conditions, provisions or terms related thereto other than those set forth in these agreements, and (ii) supersede all previous understandings, agreement(s) and representations between the parties, written or oral, relating to the subject matter hereof. The parties hereto may from time to time during the continuance of this Agreement modify, vary or alter any of the provisions of this Agreement, but only by an instrument duly executed by the parties hereto.

12.8 If any particular provision of this Agreement which substantially affects the commercial basis of this Agreement shall be determined to be invalid or unenforceable, such provision shall be amended as hereinafter provided to delete therefrom or revise the portion thus determined to be invalid or unenforceable. Such amendment shall apply only with respect to the operation of such provision of this Agreement in the particular jurisdiction for which such determination is made. In such event, the parties agree to use reasonable efforts to agree on substitute provisions, which, while valid, will achieve as closely as possible the same economic effects or commercial basis as the invalid provisions, and this Agreement otherwise shall continue in full force and effect.

12.9 The waiver by a party of any single default or breach or succession of defaults or breaches by the other shall not deprive either party of any right under this Agreement arising out of any subsequent default or breach.

12.10 All matters affecting the interpretation, validity, and performance of this Agreement shall be governed by the laws of the State of Michigan, without regard to principles of conflict of laws.

12.11 Except as specified in the attached Distribution Agreement, nothing in this Agreement authorizes either party to act as agent for the other party as to any matter. The relationship between APS and DCC is that of independent contractors.

12.12 This Agreement may be executed in two or more counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument.

12.13 The Section headings contained in this Agreement have been inserted for identification and reference purposes and shall not determine the construction or interpretation of this Agreement.

12.14 Each party hereto and its counsel have mutually contributed to the drafting of this Agreement, and no provision hereof shall be construed against any party on the grounds that a party or its counsel drafted the provision.

IN WITNESS WHEREOF, the parties have executed this Agreement.

ADVANCED POLYMER SYSTEMS, INC.

By: /s/ Michael O'Connell

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Michael O'Connell  
Senior Vice President and CFO

DOW CORNING CORPORATION

By: /s/ William P. Cavanaugh

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William P. Cavanaugh  
Commercial Unit Manager  
Personal, Household and Automotive Products

## EXHIBIT A

## JOINT AGREEMENT

THIS AGREEMENT effective the 25th day of November, 1991, by and between ADVANCED POLYMER SYSTEMS, INC. ("APS"), a Delaware corporation, and DOW CORNING CORPORATION ("DCC"), a Michigan corporation.

## R E C I T A L S

A. APS is the owner of the Patents and Patent Applications described on Exhibit A attached hereto (the APS "Patent Rights") and the Trademark described on Exhibit B attached hereto (the "APS Licensed Trademark").

B. APS possesses technical proprietary information relating to certain proprietary polymers and manufacturing equipment and know-how for preparing polymer-based carrier systems based thereon.

C. DCC is the owner of the Patents and Patent Applications described on Exhibit C attached hereto (the DCC "Patent Rights").

D. DCC possesses technical proprietary information relating to certain proprietary polymers and manufacturing equipment and know-how for preparing polymer-based carrier systems based thereon.

E. DCC possesses worldwide capabilities to market certain products for use in other products in the Field as hereinafter defined.

F. APS and DCC desire to form a joint endeavor pursuant to which APS will supply and DCC will market polymer-based carrier

systems, based on the proprietary rights of APS and DCC, for use in products in the Field.

NOW, THEREFORE, in consideration of the foregoing and of the mutual covenants and agreements hereinafter set forth, APS and DCC agree as follows:

1. Definitions. For purposes of this Agreement, the following definitions shall be applicable:

1.1 "Promissory Notes" shall be the notes described in Section 7.3 of this Agreement.

1.2 "Capital Loan" shall be the loan described in Section 7.1 of this Agreement.

1.3 "Research Loan" shall be the loan described in Section 7.2 of this Agreement.

1.4 "CTFA" shall mean the most recent edition of the Cosmetic, Toiletry and Fragrance Association Ingredient Handbook.

1.5 "Field" shall mean all CTFA listed ingredients entrapped in Microsponge(R) Systems or improvements thereon or Polytrap(R) Systems or improvements thereon or either System without entrapped ingredient or ingredients, to be used as raw materials in cosmetic, personal care, and personal household care, which are sold to primary or end-use manufacturers or distributors. Excluded are entrapments of drugs (other than over-the-counter "OTC" category I Sunscreens and OTC antiperspirant active ingredients), and any pre-existing rights of third parties described in Exhibit 2.1.

1.6 "Affiliate" shall mean a corporation or any other entity that directly, or indirectly through one or more

intermediaries, is controlled by, the designated party, but only for so long as the relationship exists. "Control" shall mean ownership of at least 50 percent of the shares of stock entitled to vote for the election of directors in the case of a corporation, and at least 50 percent of the interests in profits in the case of a business entity other than a corporation.

1.7 "Fully Burdened Costs" shall mean in connection with services to be performed by a party under the terms of this Agreement or the Manufacturing Agreement, all direct and indirect costs incurred by the party or any Affiliate in performing its obligations under this Agreement or the Manufacturing Agreement as determined in accordance with generally accepted accounting principles (based in the case of the Manufacturing Agreement on 80 percent utilization of the manufacturing facility). Such costs shall include without limitation:

- (i) salaries and wages,
- (ii) payroll taxes,
- (iii) contract labor,
- (iv) fringe benefits,
- (v) facilities (including leasehold improvements) and equipment related expenses,
- (vi) recruitment and relocation,
- (vii) communications expense,
- (viii) raw materials and supplies,
- (ix) development and prototype materials,
- (x) freight and transportation, including freight

charges for shipment of Products to DCC warehouse or customer locations,

- (xi) training and education,
- (xii) travel expenses,
- (xiii) data processing costs,
- (xiv) patent, trademark and license fees,
- (xv) insurance,
- (xvi) professional services,
- (xvii) depreciation and amortization of capital acquisitions,
- (xviii) outside purchased services,
- (xix) examples of the calculation of Fully Burdened Costs for 4 products are attached as Exhibit D.

1.8 "Gross Margin" shall mean Net Sales (whose computation shall be after reimbursement of freight and sales taxes, import duties, and other excise taxes) less cost of goods sold (which shall include the cost of active ingredients supplied by DCC or an Affiliate at the price DCC or such Affiliate charges to its most favored customer in the Field) computed in accordance with generally accepted accounting principles consistently applied.

1.9 "Joint Operating Committee" shall mean the Committee referred to in Article 4 hereof.

1.10 "Microsponge(R) System" shall mean a polymer-based delivery system as described and claimed in U.S. Patent No. 4,690,825.

1.11 "Net Sales" shall mean the total of all revenues received by DCC and its Affiliates on sales of Products to an independent, unrelated third party in a bona fide arm's length transaction, less the following deductions to the extent included in the amounts received: (i) cash and trade discounts actually allowed and taken; (ii) credits or refunds actually allowed for spoiled, damaged, outdated or returned goods; (iii) freight charges paid for delivery; (iv) sales taxes, import duties and other excise taxes; and (v) external warehousing costs. Net sales shall not include sales between DCC and any of its Affiliates or between Affiliates.

1.12 "Polytrap(R) System" shall mean a polymer-based carrier system as described and claimed in U.S. Patent No. RE 33,426 issued on November 6, 1990.

1.13 "Products" shall mean any and all Microsponge and Polytrap Systems for use in products in the Field.

1.14 "System" shall mean a Microsponge System or a Polytrap System.

1.15 "Technical Information" shall mean know-how, trade secrets, inventions, data, technology and information including improvements thereof relating to a System which are now owned or hereafter acquired by a party hereto and which such party has the lawful right to disclose. Technical Information shall include, without limitation, processes and analytical methodology used in development, testing, analysis and manufacture, and clinical, toxicological or other scientific data.

## 2. Grant of Licenses.

2.1 APS hereby licenses DCC, royalty-free, under APS Patent Rights and Technical Information to use and sell Microsponge Systems for use in the Field in all countries of the world. Such license shall be exclusive except for and subject to presently existing rights of others as set forth on Exhibit 2.1, shall be immediately effective, and shall include, but shall not be limited to, the Microsponge Systems containing entrapped silicone, vitamin A, vitamin E, mineral oil, glycerin, alphasisabolol, and humectants, it being understood that the parties agree to add or delete certain patent rights in this grant, in support of the objectives of the Agreement, which patent rights shall be contained in a writing executed by both parties, as an Addendum to this Agreement.

2.2 DCC hereby licenses APS, royalty-free, under DCC Patent Rights and Technical Information to manufacture Polytrap Systems for sale to DCC and its Affiliates for use in the Field in all countries of the world. Such license shall be exclusive, but shall not become effective until such time as APS is prepared to undertake such manufacturing at its Lafayette, Louisiana, manufacturing facilities and to supply the requirements of DCC for Systems for use in the Field, and shall include, without limitation, the Polytrap Systems containing entrapped silicone and mineral oil.

## 3. New Product Development.

3.1 APS will make available its research and development capabilities to develop new products based on its

Microsponge Systems for use in the Field as may be agreed upon by the Joint Operating Committee.

3.2 DCC will advance to APS the full cost of such agreed research. APS will reimburse DCC for one-half of such cost in accordance with the provisions of Section 7.2 hereof.

#### 4. Joint Operating Committee.

4.1 Each of APS and DCC shall promptly designate their respective representatives to a Joint Operating Committee, which shall coordinate all activities under this Agreement by unanimous decision. In the event any matter for determination by the Joint Operating Committee is not concurred in by all its then members, the parties shall consult together in good faith to endeavor to resolve the issue. Any member of the Joint Operating Committee may be replaced from time to time by notice from the party originally designating such member to the other party.

4.2 The Joint Operating Committee is authorized to determine general policy for the joint endeavor between the parties, including, but not limited to, research and development programs and budget, sales goals and policies, technical service levels and staffing, and expansion of manufacturing facilities.

4.3 The Joint Operating Committee will meet at least quarterly. Each party will also designate one of its members of the Committee as the contact person for discussion of policy questions between meetings of the Committee.

#### 5. Certain Operating Provisions.

5.1 During the term of this Agreement, DCC will not undertake, either through its own capabilities or those of any

other party except APS and as approved by the Joint Operating Committee, improvement of its Polytrap System technology in the Field or development of new products in the Field that utilize a Polytrap System.

5.2 APS will use reasonable efforts to respond timely to reasonable requests by the DCC sales and marketing force to supply custom formulation of available Microsponge or Polytrap Systems, which requests result from technical service contacts with customers and prospective customers. APS will also provide reasonable help to aid DCC in training of its sales and marketing personnel in possible applications of the Systems.

5.3 Both APS and DCC will jointly participate in the development of formulations, on behalf of customers, of products incorporating a System.

5.4 APS will provide technical services at reasonable levels to attempt solution of specific customer problems in the use of a System after prescreening by DCC of such requests.

5.5 DCC will be responsible for the pricing of Systems to customers, provided that the resulting Gross Margin will not be less than 30 percent without APS' written consent.

5.6 All new products developed by APS in the Field, whether based on a Microsponge or Polytrap System will be marketed under the Microsponge trademark, which trademark, however, shall remain the property of APS but be licensed to DCC for use in the Field during the term of the Agreement.

5.7 APS and DCC agree to decide the ownership of any jointly-developed new trademarks in a separate Agreement.

6. Division of Gross Margin.

6.1 The parties will share equally (except to the extent that DCC is entitled to reimbursement of advances by it to APS as provided herein) in the Gross Margin received by DCC and its Affiliates on Net Sales by or on behalf of DCC and its Affiliates of Microsponge and Polytrap Systems for use in the Field.

6.2 Gross Margin payments shall be made to APS within thirty (30) days following the end of each calendar quarter, and each payment shall include payments which shall have accrued during the calendar quarter immediately preceding, and shall be accompanied by a report setting forth separately the Net Sales of each Product sold during said calendar quarter in each Area, (as described in Exhibit 6.2A) and the calculation of Gross Margin payments payable for such calendar quarter. Distribution of Gross Margin payments to APS shall be net of amounts owed to DCC under the Promissory Notes attached as Exhibits 6.2B and 6.2C.

6.3 The remittance of Gross Margin payments payable on Net Sales of Products outside the United States shall be made to APS at the internal DCC Exchange Rate at which the sales were accrued. This Rate is updated monthly and used by DCC in the reporting of all DCC's operations outside the United States, less any withholding or transfer taxes which are applicable. DCC shall at APS' request supply APS with proof of payment of such taxes deducted from the Gross Margin payable to APS and paid on APS' behalf.

6.4 DCC and its Affiliates shall keep and maintain records of Net Sales of Products. Such records shall be open to inspection at any mutually agreeable time during normal business hours within three years after the payment period to which such records relate by an independent certified public accountant (or the equivalent in countries other than the United States) reasonably acceptable to DCC, but selected by APS. Said accountant shall have the right to examine the records kept pursuant to this Agreement and report findings of said examination of records to APS only insofar as it is necessary to evidence any error on the part of DCC. This right of inspection shall be exercised only once with respect to each country of sale for any calendar year. The cost of such inspection shall be borne by APS unless the result of such examination is the determination that Net Sales in a particular country have been understated by at least three percent for any calendar year in which event DCC and its Affiliates shall bear the cost.

6.5 The inspecting accountant may make an examination of the accounts contemplated above, as well as any supporting instruments and documents, and make copies of and extracts from such records for the purposes of this Agreement, provided that APS shall not be entitled to obtain or receive any information on customers or regarding manufacturing operations not related to the Products and further provided that any information obtained by APS pursuant to such examination of accounts shall be kept confidential as provided herein except as is necessary to protect

the rights of APS under this Agreement and used solely for the purpose of this Article 6.

7. Loans and Advances from DCC to APS.

7.1 Capital Loan. Upon execution of this Agreement, DCC will loan to APS the sum of One Million Dollars (\$1,000,000) as a Capital Loan which Capital Loan will be used by APS in furtherance of its obligations under this Agreement. Repayment of the Capital Loan by APS shall be as provided in Section 7.3 hereof.

7.2 Research Loan. DCC will loan to APS one-half of the full cost of research agreed to by the Joint Operating Committee pursuant to Section 3.2 hereof as a Research Loan; provided, however, the Research Loan shall not exceed at any one time One Hundred Twenty-five Thousand Dollars (\$125,000). Repayment of the Research Loan by APS shall be as provided in Section 7.3 hereof.

7.3 Promissory Notes. The obligations of APS to repay the Capital Loan and the Research Loan shall be evidenced by, and such repayment shall be made by APS in accordance with the terms and conditions of, the Promissory Notes attached hereto as Exhibits 6.2B and 6.2C. The Capital Loan and the Research Loan shall be reimbursed to DCC by APS on a periodic, interest-free basis; such periodic repayments shall be equal to twenty-five percent of APS' share of the Gross Margin with such payments being first applied to the outstanding balance under the Capital Loan and then to the Research Loan. Provided, however, the unpaid balance under the Capital Loan and the Research Loan shall

be due and payable in any event upon the earlier of five years from the date hereof or the date of termination of this Agreement. Notwithstanding the above APS' repayment obligation under the Research Loan shall be suspended upon termination of this agreement by DCC without cause or by APS with cause (as specified in Section 11.1 hereof).

7.4 Security for Loans. The Promissory Notes shall be secured by a mortgage and possessory collateral security agreement from APS to DCC on APS' real estate located at 301 Laser Lane, Lafayette, Lafayette Parish, Louisiana; such mortgage and possessory collateral security agreement shall be in the forms attached hereto as Exhibit 7.4A. The Promissory Notes shall be further secured by a security agreement given by APS to DCC on all of APS' equipment located at APS' facility at 301 Laser Lane, Lafayette, Lafayette Parish, Louisiana, pursuant to a Security Agreement to be executed by APS and DCC in the form attached as Exhibit 7.4B.

7.5 Indemnification. Notwithstanding any other provision of this Agreement to the contrary, APS shall indemnify and hold DCC harmless from any and all obligations and liabilities which DCC may incur for environmental or other damages prior to the date of foreclosure in the event DCC elects to foreclose on the manufacturing site owned and operated by APS and located in Lafayette, Louisiana. APS does hereby release and shall defend, indemnify and hold DCC harmless from any and all obligations and liabilities which may be asserted by any person or entity against DCC for contribution, set-off, indemnify or

liability in any manner whatsoever under the Capital Loan, the Research Loan or the Promissory Notes.

7.6 Corporate Resolution. APS shall furnish to DCC prior to execution of this Agreement by DCC a certified copy of a corporate resolution, still in effect, by the Board of Directors of APS authorizing the transactions set forth in this Agreement.

7.7 No Consent Required. APS represents and warrants that, to the best of APS' knowledge, no consent to any of the transactions set forth in this Article 7 is required from any holder of any prior security interest in any security provided hereunder for any loan from DCC to APS.

8. Future Capital Funding and Loans.

8.1 Provided that DCC first agrees that APS' manufacturing processes should be modified for the production of Polytrap Systems and that the estimated cost for such modification is reasonable, DCC will provide the capital funds required for such modification. The cost of any such modification paid for by DCC shall not be included in the computation of Fully Burdened Costs for any purpose hereunder.

8.2 When and if APS' manufacturing facilities reach capacity and provided that both parties agree to expand APS' capacity for manufacturing Systems for use in the Field, DCC shall arrange for capital loans deemed necessary for such expansion on such repayment terms to be negotiated at that time. For the purposes of paragraph 8.2, "reaching capacity" is to be determined on the basis of said manufacturing facilities being used solely for the manufacture of Products covered by this

Agreement. The parties agree that as of the signing of this Agreement, the best approximation of APS' manufacturing capacity for such Products is 500,000 pounds per year of unloaded Product.

8.3 All obligations of DCC under Sections 8.1 and 8.2 are expressly conditioned upon the negotiation and acceptance of terms and conditions acceptable to DCC in its sole discretion and the execution by DCC and APS of documents to effectuate the purposes of Sections 8.1 and 8.2 in a form satisfactory to counsel for DCC.

9. Manufacturing.

APS and DCC shall enter into a Purchase/Sales Agreement for the supply of Systems in the form attached hereto as Exhibit 9.

10. Term; Renewal.

10.1 The initial term of this Agreement shall be five years.

10.2 Such initial term shall be automatically renewed on a year-to-year basis unless the party desiring to terminate the Agreement gives to the other party at least two years' written advance notice of its intention to terminate.

11. Termination.

11.1 Termination For Cause. Either APS or DCC may terminate this Agreement and the licenses granted herein at any time upon breach of any of the material terms hereof by the other party (including failure to pay Gross Margin when due) upon sixty days' written notice; provided that if during said sixty days the party so notified cures the breach complained of then

this Agreement shall continue in full force and effect. In addition, APS or DCC may terminate this Agreement if (a) the other party (or any affiliated entity) becomes embroiled in circumstances which seriously degrade the terminating party's name or reputation, (b) the other party is unable to perform its obligations under this Agreement due to a contingency as provided under paragraph 15 if such inability persists for a period of longer than six months, and (c) the other party (i) commits an act of bankruptcy, (ii) is declared bankrupt, (iii) voluntarily files or has filed against it a petition for bankruptcy or reorganization unless such petition is dismissed within sixty days of filing, (iv) enters a procedure of winding up or dissolution, or (v) has a trustee or receiver appointed for its business assets or operations. Any termination under this Section 11.1 shall be for cause.

11.2 Accounting Upon Termination. In the event of termination of this Agreement for any reason by either party, DCC shall, with respect to such termination, (a) make timely payment to APS of all monies owed it under this Agreement net of amounts due from APS to DCC pursuant to the Promissory Notes and (b) make an accounting to APS of the inventory of Systems it and its Affiliates have on hand, if any, as of the date of such termination. DCC and its Affiliates shall, for a period of six months after such termination, have the right to sell such inventory, provided that the Net Sales thereof shall be subject to the division of Gross Margin obligations set forth herein.

11.3 Suspension of Research Note. Notwithstanding the provisions of Section 11.2 above, in the event of termination of this Agreement by DCC without cause or by APS with cause (as specified in Section 11.1 hereof), APS' repayment obligation under the Research Loan (pursuant to Section 7 hereof) shall be suspended upon such termination. Provided, however, such repayment obligation shall not be suspended in the event of termination by DCC with cause (as specified in Section 11.1 hereof) or by APS without cause in which case repayment shall be made by APS to DCC within thirty days of such termination.

11.4 Termination Procedure. The party terminating this Agreement shall do so by registered letter to the other party.

11.5 Termination Without Prejudice. Termination of this Agreement or any license granted hereunder shall be without prejudice to any rights of either party which may have occurred prior to such termination or the obligations of confidentiality contained in Section 14 hereof.

## 12. Assignability and Sublicensing.

12.1 This Agreement may not be assigned, nor may any sublicense of any rights be granted, by either party without the prior written consent of the other party which consent shall not be unreasonably withheld except that without consent (i) this Agreement may be assigned, and rights may be sublicensed in whole or in part, by DCC to an Affiliate of DCC or to a corporate successor of DCC; (ii) this Agreement may be assigned by DCC in whole to a person or corporation acquiring all or substantially all of the business of DCC in the Field; and (iii) this Agreement

may be assigned in whole by APS without consent to a corporate successor of APS or to a person or corporation acquiring all or substantially all of the business and assets of APS in the Field except APS shall give notice to DCC if all or substantially all of the business and/or assets of APS are going to be acquired by GE, Shinetsu, UCC, or any other basic silicone producer, at which time DCC may elect to terminate this Agreement and such termination shall be considered to be for cause.

12.2 APS agrees that DCC may enter into separate sublicense agreements with Affiliates in or outside the United States, granting such Affiliates rights to use and sell Microsponge Systems. Such sublicenses shall be subject to the same terms and conditions as contained in this Agreement to the extent permitted by the laws of the jurisdiction in which each such Affiliate is located.

12.3 No assignment or sublicense contemplated by this Article 12 shall serve to release either party from liability for the performance of its obligations hereunder.

### 13. Notices.

All notifications, demands, approvals and communications required to be made under this Agreement shall be validly given if and when made by mail prepaid and registered or certified (return receipt requested) addressed to the address of the party to whom directed (as herein set forth or the latest change thereof notified to the addressor). The parties hereto shall have the right to notify each other of changes of address during the life of this Agreement.

ADVANCED POLYMER SYSTEMS, INC.  
3696 Haven Avenue  
Redwood City, California 94063  
Attention: President

DOW CORNING CORPORATION  
Midland, Michigan 48686-0994  
Attention: General Counsel

Any such notice mailed as aforesaid shall be deemed to have been received by and given to the addressee on the date specified on the notice of receipt of delivery returned to the sender.

14. Confidentiality.

14.1 Since each party may throughout the course of the performance of this Agreement obtain access to confidential and proprietary information of the other, each party will hold in strict confidence the confidential information of the other and will treat it with the same degree of care that it exercises with regard to its own proprietary information. This obligation of confidentiality shall not prevent either party from making such disclosures to government bodies, courts or agencies as are required by law, as for example, to obtain the permission of said government body or agency to test or market any Product or to file or prosecute a patent application for any Product.

14.2 The obligation of confidentiality set out herein shall extend for a period of five years beyond the expiration or termination of this Agreement, provided however, that such obligations shall not apply to any information:

- (i) which is or becomes publicly available through no fault of the obligated party; or

- (ii) which the obligated party can show by written evidence was in its possession prior to the furnishing of same by the furnishing party; or
- (iii) which the obligated party lawfully receives from a third party.

14.3 Each party shall protect the confidential information of the other party and all Technical Information in the same manner that it protects its own confidential information which it does not wish disclosed or disseminated.

15. Force Majeure.

15.1 In the event of any failure or delay in the performance by a party of any provision of this Agreement due to acts beyond the reasonable control of such party (such as, for example, fire, explosion, strike or other difficulty with workmen, shortage of transportation equipment, accident, act of God, or compliance with or other action taken to carry out the intent or purpose of any law or regulation), then such party shall have such additional time to perform as shall be reasonably necessary under the circumstances. In the event of such failure or delay, the affected party will use its best efforts, consonant with sound business judgment and to the extent permitted by law, to correct such failure or delay as expeditiously as possible.

15.2 In the event that a party is unable to perform by a reason described in (a) above, the obligations under this Agreement thus affected shall be suspended during such time of nonperformance.

## 16. Miscellaneous.

16.1 It is the mutual desire and intent of the parties to provide certainty as to their future rights and remedies against each other by defining the extent of their mutual undertakings as provided herein. The parties have in this Agreement incorporated all representations, warranties, covenants, commitments and understandings on which they have relied in entering into this Agreement and, except as provided for herein, neither party has made any covenant or other commitment to the other concerning its future action. Accordingly, this Agreement (i) constitutes the entire agreement and understanding between the parties with respect to the matters contained herein, and there are no promises, representations, conditions, provisions or terms related thereto other than those set forth in this Agreement, and (ii) supersedes all previous understandings, agreement and representations between the parties, written or oral relating to the subject matter hereof. The parties hereto may from time to time during the continuance of this Agreement modify, vary or alter any of the provisions of this Agreement, but only by an instrument duly executed by the parties hereto.

16.2 It is the desire and intent of the parties that the provisions of this Agreement shall be enforced to the extent permissible under the laws and public policies applied in each jurisdiction in which enforcement is sought. Accordingly, if any particular provision of this Agreement which substantially affects the commercial basis of this Agreement shall be

determined to be invalid or unenforceable, such provision shall be amended as hereinafter provided to delete therefrom or revise the portion thus determined to be invalid or unenforceable, such amendment to apply only with respect to the operation of such provision of this Agreement in the particular jurisdiction for which such determination is made. In such event, the parties agree to use reasonable efforts to agree on substitute provisions, which, while valid, will achieve as closely as possible the same economic effects or commercial basis as the invalid provisions, and this Agreement otherwise shall continue in full force and effect. If the parties cannot agree to such revision within sixty days after such invalidity or unenforceability is established, the matter may be submitted by either party to arbitration as provided in this Agreement to finalize such revision.

16.3 The waiver by a party of any single default or breach of succession of defaults or breaches by the other shall not deprive either party of any right under this Agreement arising out of any subsequent default or breach.

16.4 All matters affecting the interpretation, validity, and performance of this Agreement shall be governed by the laws of the State of Michigan, without regard to principles of conflict of laws.

16.5 Nothing in this Agreement authorizes either party to act as agent for the other party as to any matter. The relationship between APS and DCC is that of independent contractors.

16.6 Any controversy or claim arising out of or relating to this Agreement or the Purchase/Sales Agreement between the parties, or the breach thereof, including controversies or claims arising out of or relating to (i) the parties' decision to enter into this Agreement, and the circumstances thereof, or (ii) patent validity or infringement issues arising under this Agreement, shall in any such case be settled by binding arbitration. Any controversy or claim arising out of this Agreement, or the breach thereof, shall be settled by arbitration before a panel of three arbitrators in accordance with the commercial arbitration rules of the American Arbitration Association, and judgment upon the award rendered by the arbitration panel may be entered in any court having jurisdiction thereof. The minimum qualifications of any arbitrator selected pursuant to this Section 16.6 shall include graduation from an accredited school of law and current admission to practice law within the United States, and in the case of the head of the arbitration panel, substantial experience in conducting contested case proceedings. Admission of any evidence in any arbitration hearing conducted pursuant to this Section 16.6 shall be governed by the Federal Rules of Evidence. In the event DCC initiates arbitration, such arbitration shall be conducted in Palo Alto, California, and in the event APS initiates arbitration, such arbitration shall be conducted in Bay City, Michigan.

16.7 This Agreement may be executed in two or more counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument.

16.8 The Section headings contained in this Agreement have been inserted for identification and reference purposes and shall not determine the construction or interpretation of this Agreement.

16.9 Each party hereto and its counsel have mutually contributed to the drafting of this Agreement, and no provision hereof shall be construed against any party on the grounds that a party or its counsel drafted the provision.

IN WITNESS THEREOF, the undersigned have caused this Agreement to be duly executed on the day first above written by their duly authorized officers.

ADVANCED POLYMER SYSTEMS, INC.

By: /s/ John J. Meakem, Jr.  
-----  
Title: President

DOW CORNING CORPORATION

By: /s/ Gary E. Anderson  
-----  
Gary E. Anderson  
Title: Group Vice President

EXHIBIT B  
PATENTS/APPLICATIONS  
US/FOREIGN

CASE NO	PATENT NO	CO	SERIAL	TITLE
DC 2901	4,880,617	US		Lattice-Entrapped Composition
DC 2979	4,762,703 1,230,560	US CA		Nitrocellulose-Free Nail Lacquer Composition
DC 3131	RE.33,429	US		Lattice-Entrapped Emollient- Moisturizer Composition
DC 3168	5,035,890	US		Emulsifier-Free Hand and Body Lotion
		GB	90106775	
		FR	90106775	
		EP	90106775	
		DE	90106775	
		BE	90106775	
	628,511 57,859	AU		
		TW		
		KR	90/4885	
		JP	92387/90	
		CA	2012892	
DC 3170	4,898,913	US		Method of Making Hydrophobic Copolymers Hydrophilic
		GB	90303226	
		FR	90303226	
		EP	90303226	
		DE	90303226	
		BE	90303226	
		JP	88432/90	
		CA	2012766	
	625,997	AU		
DC 3176	4,948,818 398,538 398,538 398,538 398,538 398,538	US NL GB FR EP DE JP		Method of Making Hydrophilic- Lipophilic Copolymeric Powders
			121431/9	
DC 3208	4,962,170	US		Method of Making Highly Absorptive Polymers
		NL	90308884	
		IT	90308884	
		GB	90308884	
		FR	90308884	
		EP	90308884	
		DE	90308884	
		JP	121431/9	

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DC 3211	4,961,532 51,199	US TW KR JP AU	90/10206 177648/9	Fragrance Release Device Containing A Highly Adsorptive Copolymer
	640,670			
DC 3228	4,962,133 417,606 417,606 417,606 417,606 417,606 417,606	US NL IT GB FR EP DE JP	235461/9	Method of Making Highly Adsorptive Copolymers
DC 3245	5,037,485 57,156 629,040	US TW AU		Method of Cleaning Surfaces
DC 3273	5,102,662	US CA	2030829	Insect Repellent Plastic
DC 3283	5,208,038	US		Coacervated Highly Absorptive Polymers
DC 3284	5,135,989	US		Method of Making Hydrophobic Copolymers Hydrophilic
DC 3388	5,246,972 450,656 450,656 450,656	US GB EP DE JP	100261/9	Polish Containing Highly Adsorptive Polymer
DC 3413	5,169,904	US		Method of Making Hydrophobic Copolymers Hydrophilic
DC 3414	5,026,781	US		Method of Making Hydrophobic Copolymers Hydrophilic
DC 3447	5,281,413	US JP CA	256883/9 2050259	Antiperspirant Stick Containing A Macroporous Polymer
DC 3451	5,387,411	US JP CA	256881/9 2050188	Antiperspirant Containing A Hydrophobic Macroporous Polymer as the Suspending Agent
DC 3491	5,135,660	US JP	432/92	Method of Recovering Oil from the Surface of Water
DC 3538	5,145,685	US JP	85151/92	Skin Treatment Method and Composition

DC 3919	5,350,679	US		Repeat Insult Microbial Test Method
		GB	94304152	
		FR	94304152	
		EP	94304152	
		DE	94304152	
		AU	64675/95	
		JP	130731/9	
		KR	94/13216	
DC 3947		US	103,318	Method of Making Hydrophobic Copolymers Hydrophilic
DC 4042	5,409,695	US		Method of Increasing Deposition of Silicone Conditioner to Hair
		IT	95300979	
		GB	95300979	
		FR	95300979	
		ES	95300979	
		EP	95300979	
		DE	95300979	
		JP	33947/95	
		CA	2142511	
DC 4139		US	307,121	Adsorption of Sweat Components with A Macroporous Copolymer

## EXHIBIT C

## REGISTRATION RIGHTS AGREEMENT

January 23, 1996

Advanced Polymer Systems, Inc., a Delaware corporation ("APS") and Dow Corning Corporation, a Michigan corporation ("PURCHASER"), hereby agree as follows:

## RECITALS

A. APS is acquiring a polymer-based carrier system business from PURCHASER, and in payment thereof is issuing 200,000 shares of its Common Stock (the "Shares") to PURCHASER.

B. The parties wish to provide for the registration of the subsequent resale of the Shares and for the orderly distribution thereof, all on the terms and conditions hereof.

## THE PARTIES AGREE AS FOLLOWS:

## 1. Registration Rights; Listing.

1.1 Certain Definitions. As used herein, the following terms shall have the following respective meanings:

(a) "Commission" shall mean the Securities and Exchange Commission or any other federal agency at the time administering the Securities Act.

(b) "Convertible Securities" shall mean securities of APS convertible into or exchangeable for Registrable Securities.

(c) "Holder" shall mean any holder of outstanding Registrable Securities which have not been sold to the public, but only if such holder is PURCHASER or an assignee or transferee of Registration rights as permitted by Section 1.8.

(d) The terms "Register", "Registered" and "Registration" refer to a registration effected by preparing and filing a registration statement in compliance with the Securities Act ("Registration Statement"), and the declaration or ordering of the effectiveness of such Registration Statement.

(e) "Registrable Securities" shall mean the Shares issued to PURCHASER by APS, together with any Common Stock issued with respect to the Shares pursuant to stock splits, stock dividends and similar distributions, so long as such securities have not been sold to the public in a public distribution or a public securities transaction or sold in a single transaction exempt from the registration and prospectus delivery requirements of the Securities Act such that all transfer restrictions and restrictive legends with respect to such Shares shall have been removed in connection with such sale.

(f) "Registration Expenses" shall mean all expenses incurred by APS in complying with this Agreement, including, without limitation, all federal and state registration, qualification and filing fees, printing expenses, fees and disbursements of counsel for APS, blue sky fees and expenses, the expense of any special audits incident to or required by any such Registration and any expenses related to the maintenance of such Registration and qualification during the period specified in Section 1.4(a) hereof.

(g) "Securities Act" shall mean the Securities Act of 1933, as amended, or any similar federal statute, and the

rules and regulations of the Commission thereunder, all as the same shall be in effect at the time.

(h) "Selling Expenses" shall mean all underwriting discounts and selling commissions applicable to the sale of Registrable Securities pursuant to this Agreement.

## 1.2 Registration.

1.2.1 Registration. Subject to the terms of this Agreement, APS shall use its best efforts to effect Registration of the Registrable Securities within 60 days of their issuance to PURCHASER by filing as soon as possible after the date hereof a Form S-3 Registration Statement (or any successor to Form S-3) with the Commission.

1.2.2 Registration of Other Securities. Any Registration Statement filed under this Section 1 may include securities of APS other than Registrable Securities; provided, however, that neither PURCHASER or any Holder shall be required to utilize an underwriter in connection with the sale of their Registrable Securities.

1.2.3 Blue Sky. In the event of any Registration pursuant to Section 1, APS will exercise its best efforts to Register and qualify the securities covered by the Registration Statement under such other securities or Blue Sky laws of such jurisdictions as shall be reasonably appropriate for the distribution of such securities; provided, however, that:

(a) APS shall not be required to qualify to do business or to file a general consent to service of process in

any such states or jurisdictions, unless APS is already subject to service in such jurisdiction; and

(b) notwithstanding anything in this Agreement to the contrary, in the event any jurisdiction in which the securities shall be qualified imposes a non-waivable requirement that expenses incurred in connection with the qualification of the securities be borne by selling shareholders, such expenses shall be payable pro rata by selling shareholders.

1.3 Expenses of Registration. All Registration Expenses (but not Selling Expenses) incurred in connection with the Registration pursuant to Section 1 shall be borne by APS.

1.4 Registration Procedures. Whenever required under this Agreement to effect the Registration of any securities of APS, subject to the other provisions of this Agreement, APS shall, as expeditiously as reasonably possible:

(a) Prepare and file with the Commission a Registration Statement with respect to such securities in accordance with Section 1.2.1 and use its diligent best efforts to cause such Registration Statement to become effective as promptly as possible thereafter and to remain effective for a period equal to the shorter of: (i) three years from the date of such effectiveness; or (ii) until the distribution described in the Registration Statement has been completed.

(b) Prepare and file with the Commission such amendments and supplements to such Registration Statement and the prospectus used in connection with such Registration Statement as may be necessary to comply with the provisions of the Securities

Act with respect to the disposition of all securities covered by such Registration Statement.

(c) Furnish to the Holders participating in such Registration and the underwriters, if any, of the securities being Registered, such reasonable number of copies of the Registration Statement, preliminary prospectus and final prospectus as they may request in order to facilitate the public offering of such securities.

1.5 Additional Information Available. So long as the Registration Statement is effective covering the resale of Shares owned by a Holder, APS will furnish to the Holder(s):

(a) as soon as practicable after it becomes available (but in the case of APS' Annual Report to Stockholders, within 120 days after the end of each fiscal year of APS), one copy of: (i) its Annual Report to Stockholders (which Annual Report shall contain financial statements audited in accordance with generally accepted accounting principles by a national firm of certified public accountants); (ii) if not included in substance in the Annual Report to Stockholders, its Annual Report on Form 10-K; (iii) if not included in substance in its Quarterly Reports to Stockholders, its quarterly reports on Form 10-Q; and (iv) a full copy of the particular Registration Statement covering the Shares (the foregoing, in each case, excluding exhibits); and

(b) upon the reasonable request of a Holder, all exhibits excluded by the parenthetical to subparagraph (a) (iv) of this Section 1.5;

and APS, upon the reasonable request of a Holder, will meet with such Holder or a representative thereof at APS' headquarters to discuss all information relevant for disclosure in the Registration Statement covering the Shares and will otherwise cooperate with any Holder conducting an investigation for the purpose of reducing or eliminating such Holder's exposure to liability under the Securities Act, including the reasonable production of information at APS' headquarters.

1.6 Information Furnished by Holder. It shall be a condition precedent of APS' obligations under this Agreement that each Holder of Registrable Securities included in any Registration furnish to APS such information regarding such Holder and the distribution proposed by such Holder as APS may reasonably request.

1.7 Indemnification.

1.7.1 Company's Indemnification of Holder. APS will indemnify and hold harmless each Holder, each of its officers, directors, employees, agents, affiliates and constituent partners, and each person deemed to be in control of such Holder within the meaning of Section 15 of the Securities Act or Section 20 of the Securities Exchange Act of 1934 (the "Exchange Act"), from and against all claims, losses, damages or liabilities (or actions in respect thereof) to the extent such claims, losses, damages or liabilities arise out of or are based upon any untrue statement (or alleged untrue statement) of a material fact contained in any prospectus or other document (including any related Registration Statement) incident to any

such Registration, qualification or compliance, or are based on any omission (or alleged omission) to state therein a material fact required to be stated therein or necessary to make the statements therein not misleading, or any violation by APS of any rule or regulation promulgated under the Securities Act applicable to APS and relating to action or inaction required of APS in connection with any such Registration, qualification or compliance or arise out of any failure by APS to fulfill an undertaking included in the Registration Statement; and APS will reimburse each such Holder, each such underwriter and each person who controls any such Holder or underwriter, for any legal and any other expenses reasonably incurred in connection with defending any such claim, loss, damage, liability or action; provided, however, that the indemnity contained in this Section 1.7.1 shall not apply to amounts paid in settlement of any such claim, loss, damage, liability or action if settlement is effected without the consent of APS (which consent shall not unreasonably be withheld) and; provided, further, that APS will not be liable in any such case to the extent that any such claim, loss, damage, liability or expense arises out of or is based upon any untrue statement or omission based upon written information furnished to APS by such Holder or controlling person and stated expressly to be for use in connection with the offering of securities of APS.

1.7.2 Holder's Indemnification of Company. Each Holder will indemnify and hold harmless APS, each of its directors, officers, employees, agents and affiliates, each

person deemed to be in control of APS within the meaning of Section 15 the Securities Act or Section 20 of the Exchange Act, and each other such Holder, each of its officers, directors, employees, agents, affiliates and constituent partners, and each person deemed to be in control of such other Holder within the meaning of Section 15 of the Securities Act or Section 20 of the Exchange Act, from and against all claims, losses, damages and liabilities (or actions in respect thereof) arising out of or based upon any untrue statement (or alleged untrue statement) of a material fact contained in any such Registration Statement, prospectus, offering circular or other document, or any omission (or alleged omission) to state therein a material fact required to be stated therein or necessary to make the statements therein not misleading, or any violation by such Holder of any rule or regulation promulgated under the Securities Act applicable to such Holder and relating to action or inaction required of such Holder in connection with any such Registration, qualification or compliance; and will reimburse APS, such Holder, such directors, officers, partners, persons or control persons for any legal and any other expenses reasonably incurred in connection with defending any such claim, loss, damage, liability or action, in each case to the extent, but only to the extent, that such untrue statement (or alleged untrue statement) or omission (or alleged omission) is made in such Registration Statement, prospectus, offering circular or other document in reliance upon and in conformity with written information furnished to APS by such Holder and specifically approved in writing by such Holder for

use in connection with the offering of securities of APS; provided, however, that the indemnity contained in this Section 1.7.2 shall not apply with respect to a Holder to amounts paid in settlement of any claim, loss, damage, liability or action if settlement is effected without the consent of such Holder (which consent shall not be unreasonably delayed or withheld).

1.7.3 Indemnification Procedure. Promptly after receipt by an indemnified party under this Section 1.7 of notice of the commencement of any action, such indemnified party will, if a claim in respect thereof is to be made against an indemnifying party under this Section 1.7, notify the indemnifying party in writing of the commencement thereof and, to the extent reasonably possible, generally summarize such action. The indemnifying party shall have the right to participate in and to assume the defense of such claim; provided, however, that the indemnifying party shall be entitled to select counsel for the defense of such claim with the approval of any parties entitled to indemnification, which approval shall not be unreasonably withheld; provided, further, that if either party reasonably determines that there may be a conflict between the position of APS and a Holder in conducting the defense of such action, suit or proceeding by reason of recognized claims for indemnity under this Section 1.7, then counsel for such party shall be entitled to conduct, or participate in, the defense to the extent reasonably determined by such counsel to be necessary to protect the interest of such party and the costs of such counsel shall be borne by the indemnifying party. The failure to notify an

indemnifying party promptly of the commencement of any such action, if prejudicial to the ability of the indemnifying party to defend such action, shall relieve such indemnifying party, to the extent so prejudiced, of any liability to the indemnified party under this Section 1.7, but the omission so to notify the indemnifying party will not relieve such party of any liability that such party may have to any indemnified party otherwise other than under this Section 1.7.

1.8 Transfer of Rights. The right to cause APS to Register securities granted by APS to PURCHASER under this Agreement may be assigned by any Holder to a transferee or assignee of any Registrable Securities not sold to the public acquiring at least 25,000 shares of such Holder's Registrable Securities (equitably adjusted for any stock splits, subdivisions, stock dividends, changes, combinations or the like); provided, however, that:

(a) APS must receive written notice prior to the time of said transfer, stating the name and address of said transferee or assignee and identifying the securities with respect to which such information and Registration rights are being assigned; and

(b) the transferee or assignee of such rights must not be a person deemed by the Board of Directors of APS, in its best judgment, to be a competitor or potential competitor of APS. Notwithstanding the limitations set forth in the foregoing sentence respecting the minimum number of shares which must be transferred and permitted transferees and assignees: (i) any

Holder which is a partnership may transfer such Holder's Registration rights to such Holder's constituent partners without restriction as to the number or percentage of shares acquired by any such constituent partner; and (ii) Section 1.8(b) shall not prohibit the transfer or assignment of such rights to an affiliate of the PURCHASER.

1.9 Nasdaq Listing. Prior to the effective date of a Registration of any of the Shares, APS shall file an application with NASDAQ to list such Shares for quotation on the Nasdaq National Market.

1.10 Delay in Effectiveness. In the event a Registration Statement covering the Shares is not declared effective within ninety (90) days after the date hereof or in the event the effectiveness of such Registration Statement is suspended or terminated at any time subsequent to the 90th day after the date hereof and prior to the termination of the period specified in Section 1.4(a) hereof, APS shall pay to the Holders an amount equal to \$275 per day for each day such Registration Statement is not effective; provided that nothing herein is intended to limit a Holder's ability to seek to enforce its rights to require that a Registration Statement covering Shares remains effective during the period specified in Section 1.4 hereof; and provided further that APS shall not be required to make any payments to a Holder if the failure to obtain or maintain an effective Registration Statement is solely attributable to a Holder's failure to provide APS with

information required to be provided by such Holder for inclusion in the Registration Statement.

2. Miscellaneous.

2.1 Governing Law. This Agreement shall be governed by and construed in accordance with the laws of the State of California applicable to contracts entered into and wholly to be performed within the State of California by California residents.

2.2 Successors and Assigns. Subject to the exceptions specifically set forth in this Agreement, the terms and conditions of this Agreement shall inure to the benefit of and be binding upon the respective executors, administrators, heirs, successors and assigns of the parties.

2.3 Entire Agreement. This Agreement and the Asset Purchase Agreement and the Exhibits and Schedules hereto and thereto constitute the entire contract between APS and the PURCHASER relative to the subject matter hereof. Any previous agreement between APS and the PURCHASER with respect to the subject matter hereof is superseded by this Agreement.

2.4 Severability. Any invalidity, illegality or limitation of the enforceability with respect to any Holder of any one or more of the provisions of this Agreement, or any part thereof, whether arising by reason of the law of any PURCHASER's domicile or otherwise, shall in no way affect or impair the validity, legality or enforceability of this Agreement with respect to other Holders. In case any provision of this Agreement shall be invalid, illegal or unenforceable, it shall to the extent practicable, be modified so as to make it valid, legal

and enforceable and to retain as nearly as practicable the intent of the parties, and the validity, legality and enforceability of the remaining provisions shall not in any way be affected or impaired thereby.

2.5 Amendment of Agreement. Any provision of this Agreement may be amended only by a written instrument signed by APS and by PURCHASER.

2.6 Notices. Any notice required or permitted hereunder shall be given in writing and shall be conclusively deemed effectively given upon personal delivery, or five days after deposit in the United States mail, by registered or certified mail, postage prepaid, addressed:

(a) if to APS, Advanced Polymer Systems, Inc., 3696 Haven Avenue, Redwood City, California 94063, ATTENTION: President; and

(b) if to PURCHASER, Dow Corning Corporation, 2200 W. Salzburg Road, Midland, Michigan 48686-0994, ATTENTION: General Counsel.

2.7 Headings. The headings of the Sections of this Agreement are for convenience and shall not by themselves determine the interpretation of this Agreement.

2.8 Counterparts. This Agreement may be executed in two or more counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument.

IN WITNESS WHEREOF, the parties have executed this Agreement.

ADVANCED POLYMER SYSTEMS, INC.

By: /s/ Michael O'Connell

\_\_\_\_\_  
Michael O'Connell  
Senior Vice President and CFO

DOW CORNING CORPORATION

By: /s/ William P. Cavanaugh

\_\_\_\_\_  
William P. Cavanaugh  
Commercial Unit Manager  
Personal Household and  
Automotive Products

## EXHIBIT D

## ASSIGNMENT

For value received, the sufficiency, adequacy and receipt of which is hereby acknowledged, DOW CORNING CORPORATION, a Michigan corporation, having its principal office in Midland, Michigan, sells, assigns, transfers and releases unto ADVANCED POLYMER SYSTEMS, INC., a Delaware corporation, having its principal place of business at Redwood City, California, all of its right, title and interest of whatsoever nature in and to the following United States Letters Patents:

Patent Number -----	Patent Number -----	Patent Number -----
Re.33,429	5,026,781	5,169,904
4,762,703	5,035,890	5,208,038
4,880,617	5,037,485	5,246,972
4,898,913	5,102,662	5,281,413
4,948,818	5,135,660	5,350,679
4,961,532	5,135,989	5,387,411
4,962,133	5,145,685	5,409,695
4,962,170		

and in and to the following United States Patent Applications:

Serial Number -----
103,318
307,121

and in and to the following Foreign Patents:

Country -----	Patent Number -----
Australia	628,511
Australia	625,997
Australia	640,670
Canada	1,230,560
European	398,538
European	417,606
European	450,656
European	629,040
Taiwan	51,199

Taiwan	57,156
Taiwan	57,859

and in and to the following Foreign Patent Applications:

Country	Serial Number
-----	-----
Australia	64675/94
Canada	2012766
Canada	2012892
Canada	2030829
Canada	2050188
Canada	2050259
Canada	2142511
European	90106775
European	90303226
European	90308884
European	94304152
European	95300979
Japan	432/92
Japan	33947/95
Japan	85151/92
Japan	88432/90
Japan	92387/90
Japan	100261/9
Japan	121431/9
Japan	130731/9
Japan	177648/9
Japan	235461/9
Japan	256881/9
Japan	256883/9
Korea	90/ 4885
Korea	90/10206
Korea	94/13216

and in and to all inventions described and claimed therein, and also in and to any and all other U.S. and Foreign Patents, Reissue Patents and/or Patent Applications deriving in any way out of said U.S. and Foreign Patents, and the above listed U.S. and Foreign Patent Applications, and further including the entire right, title and interest in and to any and all causes of action arising out

of all past, present and future infringement of said U.S. and Foreign Patents, and Patent Applications.

The effective date of this Assignment is \_\_\_\_\_ .

\_\_\_\_\_  
Leon D. Crossman  
Vice President and  
Executive Director  
Science & Technology

STATE OF MICHIGAN        )  
                                  )  
COUNTY OF BAY            )        SS

BEFORE ME, \_\_\_\_\_, a Notary Public in and for Bay County, Michigan, on this day personally appeared Leon D. Crossman, Vice President and Executive Director, S&T, known to me to be the person and officer whose name is subscribed to the foregoing instrument and acknowledged to me that he executed the same as the act of such corporation for the purposes and consideration therein expressed, and in the capacity therein stated.

GIVEN UNDER MY HAND AND SEAL OF OFFICE this \_\_\_\_ day of \_\_\_\_\_, 1996.

My commission expires on the \_\_\_\_\_day of \_\_\_\_\_, 19\_\_\_\_.

EXHIBIT E

TRADEMARK ASSIGNMENT

WHEREAS, Dow Corning Corporation, a Michigan corporation ("Dow Corning"), has adopted, used and is using or has intent to use the marks which are registered or pending registration and which are listed in the attached Schedule;

AND WHEREAS, Advanced Polymer Systems, Inc., a Delaware corporation ("APS"), is desirous of acquiring said marks and the registrations thereof;

NOW, THEREFORE, for good and valuable consideration, receipt of which is hereby acknowledged, said Dow Corning does hereby assign unto the said APS all right, title and interest in and to the said marks, together with the goodwill of the business symbolized by the marks and the attached identified registrations thereof.

DOW CORNING CORPORATION

By: /s/ James R. Jenkins

\_\_\_\_\_  
James R. Jenkins  
Vice President, Secretary and  
General Counsel

State of Michigan)  
                  )ss  
County of Bay   )

On this \_\_\_\_\_ day of December 1995, before me appeared James R. Jenkins, the person who signed this instrument, who acknowledged that he signed it as a free act on behalf of the identified corporation.

\_\_\_\_\_  
Notary Public

## SCHEDULE FOR EXHIBIT E

## U.S. AND FOREIGN POLYTRAP TRADEMARK REGISTRATIONS

TRADEMARK	COUNTRY	STATUS	REGISTRATION DATE	REGISTRATION NUMBER	GOODS
POLYTRAP	AUSTRALIA	REGISTERED	05/07/82	A375,235	CHEMICALS AND CHEMICAL PRODUCTS IN THIS CLASS, INCLUSIVE OF POLYMER USED FOR ENTRAPPING SOLID AND/OR LIQUID MATERIALS.
POLYTRAP	CANADA	REGISTERED	11/10/83	284,921	CHEMICALS, NAMELY: A POLYMER USED FOR ENTRAPPING SOLID OR LIQUID MATERIALS.
POLYTRAP	DENMARK	REGISTERED	06/13/86	1403/1986	CHEMICAL PRODUCTS FOR INDUSTRIAL USE, NAMELY POLYMER USED FOR ENTRAPPING SOLID AND/OR LIQUID MATERIALS.
POLYTRAP	FRANCE	REGISTERED	08/04/82	1,210,886	CHEMICALS -- NAMELY, POLYMER USED FOR ENTRAPPING SOLID AND/OR LIQUID MATERIALS.
POLYTRAP	GERMANY	REGISTERED	08/07/82	1 054 970	CHEMICALS, POLYMER
POLYTRAP	ITALY	REGISTERED	03/03/86	408599	CHEMICALS -- NAMELY, POLYMER USED FOR ENTRAPPING SOLID AND/OR LIQUID MATERIALS.
POLYTRAP	JAPAN	REGISTERED	03/25/85	1752867	CHEMICALS -- NAMELY, POLYMER USED FOR ENTRAPPING SOLID AND/OR LIQUID MATERIALS.
POLYTRAP	SWITZERLAND	REGISTERED	05/05/82	318568	CHEMICALS -- NAMELY, POLYMER USED FOR ENTRAPPING SOLID AND/OR LIQUID MATERIALS.

## SCHEDULE FOR EXHIBIT E

## U.S. AND FOREIGN POLYTRAP TRADEMARK REGISTRATIONS

TRADEMARK	COUNTRY	STATUS	REGISTRATION DATE	REGISTRATION NUMBER	GOODS
POLYTRAP	UNITED KINGDOM	REGISTERED	05/06/82	B1,174,500	CHEMICAL PRODUCTS, BEING POLYMERS FOR ENTRAPPING SOLID AND/OR LIQUID MATERIALS.
POLYTRAP	UNITED STATES	REGISTERED	10/05/82	1,211,149	
POLYTRAP FLM	CANADA	REGISTERED	06/14/85	303 665	CHEMICAL - NAMELY, POLYMER USED FOR ENTRAPPING SOLID AND/OR LIQUID MATERIALS.
POLYTRAP FLM	DENMARK	REGISTERED	07/04/86	1587/1986	CHEMICALS - NAMELY, POLYMER USED FOR ENTRAPPING SOLID AND/OR LIQUID MATERIALS.
POLYTRAP FLM	ITALY	REGISTERED	04/13/88	491490	CHEMICALS - NAMELY, POLYMER USED FOR ENTRAPPING SOLID AND/OR LIQUID MATERIALS.
POLYTRAP FLM	SWITZERLAND	REGISTERED	05/20/83	325569	CHEMICALS - NAMELY, POLYMER USED FOR ENTRAPPING SOLID AND/OR LIQUID MATERIALS.
POLYTRAP FLM	UNITED KINGDOM	REGISTERED	05/31/83	B1,196,850	CHEMICALS - NAMELY, POLYMER USED FOR ENTRAPPING SOLID AND/OR LIQUID MATERIALS.
POLYTRAP FLM	UNITED STATES	REGISTERED	02/21/84	1,267,508	CHEMICALS - NAMELY, POLYMER USED FOR ENTRAPPING SOLID AND/OR LIQUID MATERIALS.

## SCHEDULE FOR EXHIBIT E

## U.S. AND FOREIGN POLYTRAP TRADEMARK REGISTRATIONS

TRADEMARK	COUNTRY	STATUS	REGISTRATION DATE	REGISTRATION NUMBER	GOODS
POLYTRAP SMP	CANADA	REGISTERED	12/21/84	298 275	CHEMICAL - NAMELY, POLYMER USED FOR ENTRAPPING SOLID AND/OR LIQUID MATERIALS.
POLYTRAP SMP	ITALY	REGISTERED	04/13/88	491491	CHEMICALS - NAMELY, POLYMER USED FOR ENTRAPPING SOLID AND/OR LIQUID MATERIALS.
POLYTRAP SMP	JAPAN	REGISTERED	09/21/87	1,982,992	CHEMICALS - NAMELY, POLYMER USED FOR ENTRAPPING SOLID AND/OR LIQUID MATERIALS.
POLYTRAP SMP	UNITED KINGDOM	REGISTERED	00/00/0000	B1,196,851	CHEMICALS - NAMELY, POLYMER USED FOR ENTRAPPING SOLID AND/OR LIQUID MATERIALS.
POLYTRAP SMP	UNITED STATES	REGISTERED	02/21/84	1,267,515	CHEMICALS - NAMELY, POLYMER USED FOR ENTRAPPING SOLID AND/OR LIQUID MATERIALS.

## EXHIBIT F

## DISTRIBUTION AGREEMENT

THIS DISTRIBUTION AGREEMENT is made and entered into this \_\_\_ day of \_\_\_\_\_, 1996, by and between Dow Corning Corporation, a corporation organized and existing the laws of the State of Michigan and having its principal place of business at 2200 West Salzburg Road, Midland, Michigan 48686-0994 ("DCC"), and Advanced Polymer Systems, Inc. ("APS"), a corporation organized and existing under the laws of the State of Delaware having its principal place of business at 3696 Haven Avenue, Redwood City, California 94063.

WHEREAS, DCC and APS have entered into an Asset Purchase Agreement dated \_\_\_\_\_, 1996, wherein APS desires to appoint DCC, and DCC is willing to accept the appointment, to act as a non-exclusive distributor to sell Microsponge(R) and Polytrap(R) Systems ("Systems") to customers located within and outside of the United States ("Customers").

NOW, THEREFORE, in consideration of the following covenants and obligations, and subject to the conditions and limitations set forth here, the parties agree as follows:

## ARTICLE I. DEFINITIONS

All capitalized terms not defined herein shall have the same meaning as defined in the Asset Purchase Agreement.

Unless otherwise specifically set forth herein, the following terms shall have the following meanings:

1.1 "Distribution Agreement", with no other modification or description, refers to this Distribution Agreement.

1.2 "Gross Sales Revenues" shall mean the total sales revenues in local currency derived by APS from the sale of Systems to Customers sold by DCC, less (a) returns and allowances, and (b) shipping expenses, freight and duty, in accordance with the appointment hereunder.

1.3 "Joint Agreement" shall mean that certain agreement between DCC and APS effective November 25, 1991, which provides for the supply and purchase of the Systems.

#### ARTICLE II. APPOINTMENT OF DCC

APS hereby appoints DCC, and DCC hereby accepts the appointment by APS, to act as APS non-exclusive distributor of the Systems to Customers for the period commencing on the date hereof and ending on \_\_\_\_\_, or such earlier date mutually acceptable to DCC and APS ("Term"). During the Term, APS may also sell Systems directly to Customers.

#### ARTICLE III. DISTRIBUTOR PRICES

APS shall continue to sell Systems to DCC at the same price and under the same terms at which DCC has been purchasing Systems pursuant to the Joint Agreement. Customer prices shall be determined by APS.

#### ARTICLE IV. SALES LEADS

As appropriate, DCC shall provide to APS any industry contracts or potential sales leads that arise during the Term.

#### ARTICLE V. DELIVERY TO CUSTOMERS

DCC will work with APS to arrange for all orders of Systems to be drop-shipped to Customer's plant. If APS is unable to arrange for drop-shipment, DCC shall be reimbursed by APS for all shipping expenses, overseas freight and duty, as applicable, incurred by DCC.

## ARTICLE VI. COMMISSION

In consideration for the foregoing to be performed by DCC, APS agrees to pay to DCC, in U.S. dollars, a commission in the amount of three percent (3%) of the Gross Sales Revenues ("Commissions").

## ARTICLE VII. STATEMENTS AND PAYMENT

DCC shall pay APS, on a quarterly basis, the Gross Sales Revenue, netted by Commissions earned and shipping expenses incurred for the period. Each payment shall be accompanied by a statement setting forth the amount of Gross Sales Revenue, Commissions earned and shipping expenses, overseas freight and duty incurred for the period.

## ARTICLE VIII. ACTS CONSTITUTING BREACH

8.1 Unless waived by DCC, the following acts shall be deemed to constitute breach of this Distribution Agreement by APS:

8.1.1 The nonperformance by APS of any material provision of this Distribution Agreement;

8.1.2 The insolvency or dissolution of APS;

8.1.3 The filing of a petition seeking relief under any federal bankruptcy law by or against APS; or

8.1.4 An application by APS for receivership, an assignment for the benefit of APS' creditors, or an admission by APS that it is unable to pay its debts or meet its obligations.

8.2 Unless waived by APS, the nonperformance by DCC of any material provision of this Distribution Agreement shall be deemed to constitute breach of this Distribution Agreement by DCC.

## ARTICLE IX. REMEDIES UPON BREACH

9.1 In the event APS shall breach this Agreement as provided in Paragraph 8.1, this Agreement shall terminate and DCC shall be entitled to pursue any available remedies, whether legal or equitable, against APS.

9.2 In the event DCC shall breach this Agreement as provided in Paragraph 8.2, this Agreement shall terminate and APS shall be entitled to pursue any available remedies, whether legal or equitable, against DCC.

## ARTICLE X. GOVERNING LAW

This Distribution Agreement, regardless of where signed, shall be governed by the law of the State of Michigan without giving effect to any principles of conflict of law.

## ARTICLE XI. ENTIRE AGREEMENT AND AMENDMENT

This Distribution Agreement contains the entire agreement between the parties in respect to the subject matter hereof and can only be altered or amended by a written document or instrument signed by DCC and APS. No modification of, addition to, extension of or waiver of any of the terms of this Distribution Agreement shall be binding on the other party unless in writing and signed by an authorized representative of such party.

## ARTICLE XII. INVALID OR UNENFORCEABLE TERMS

If any term or provision of this Distribution Agreement is deemed invalid or unenforceable by reason of law, this Distribution Agreement shall be construed in such a manner as to delete that term or provision held to be invalid or unenforceable and all other terms and provisions of this Distribution Agreement shall remain in full force and effect. To the extent that any term or provision is invalid or unenforceable by limitation or in part, then that term or provision shall be enforceable to the fullest extent permitted by law.

ARTICLE XIII. NOTICE

Any notice to APS provided for in this Distribution Agreement shall be given by mailing such notice, or certified mail, return receipt requested, addressed to 3696 Haven Avenue, Redwood City, California 94063, or to such other address as APS may designate by written notice to DCC. Any notice to DCC shall be given by mailing such notice, certified mail, return receipt requested, addressed to DCC at 2200 West Salzburg Road, Midland, Michigan 48686-0994, Attention: General Counsel or to such other address as DCC may designate by written notice to APS. Any notice issued in accordance with this Distribution Agreement shall be deemed to have been received by the appropriate party two (2) business days after being so mailed.

IN WITNESS WHEREOF, the parties have executed this Distribution Agreement.

DOW CORNING CORPORATION

ADVANCED POLYMER SYSTEMS, INC.

By: \_\_\_\_\_  
William P. Cavanaugh  
Commercial Unit Manager  
Personal, Household and  
Automotive Products

By: \_\_\_\_\_  
Title: \_\_\_\_\_

## EXHIBIT G

## NON-COMPETE AGREEMENT

THIS NON-COMPETE AGREEMENT ("Non-Compete Agreement") is made this \_\_\_\_\_ day of \_\_\_\_\_, 1996, by and between Advanced Polymer Systems Inc., a Corporation organized and existing under the laws of the State of Delaware ("Purchaser"), and Dow Corning Corporation, a Corporation organized and existing under the laws of the State of Michigan ("DCC").

## W I T N E S S E T H:

WHEREAS, Purchaser and DCC have entered into an Asset Purchase Agreement dated \_\_\_\_\_ related to the sale, transfer, and assignment, from DCC to Purchaser of DCC's POLYTRAP(R) patents, trademarks, and technology; and

WHEREAS, the Asset Purchase Agreement in Paragraph 5 provides that Purchaser and DCC shall enter into a non-compete agreement on the terms and conditions contained herein.

NOW, THEREFORE, in consideration of the premises and the mutual covenants herein contained, the receipt and adequacy of which is hereby acknowledged, the parties hereto hereby agree as follows:

## SECTION 1. Definitions

1.1 All capitalized terms not defined herein shall have the same meaning as defined in the Asset Purchase Agreement.

1.2 Unless otherwise specifically set forth herein, the following terms shall have the following meanings:

1.2.1 "Field " shall mean a POLYTRAP(R) polymer-based carrier system, with or without entrapped ingredient(s), to be used as a raw material(s), which raw material(s) is sold to primary or end-use manufacturers or distributors. Other than over-the-counter (OTC) sunscreens and OTC antiperspirant active ingredients, entrapment of drugs is excluded.

1.2.2 "POLYTRAP(R)" shall mean a polymer-based carrier system as described and claimed in US Patent No. Re. 33,429, issued on November 6, 1990.

## SECTION 2. Covenant Not to Compete.

2.1 In the Asset Purchase Agreement of even date herewith, DCC has agreed to sell, transfer, and assign, to PURCHASER all of DCC s rights in the POLYTRAP(R) System Assets.

2.2 Except as provided in Section 4 of the Asset Purchase Agreement, DCC hereby agrees not to engage, directly or indirectly, in the United States, or in any foreign country, in which the POLYTRAP(R) System is presently being sold or utilized in products, either alone or in association with any other person, firm, corporation, or any other business organization, in the business of creating, licensing, manufacturing, or marketing, POLYTRAP(R) polymer-based carrier systems for use in the Field.

2.3 The period of time during which DCC is prohibited from engaging in the activities enumerated in Section 2.2 hereof shall commence on the date hereof and end on December 31, 2005, or end on the date when Purchaser ceases to carry on like business, whichever occurs first.

2.4 Nothing in this Non-Compete Agreement shall be construed as prohibiting DCC from supplying organosilicon compounds, silicones, silanes, or organo-modified silicones or silanes, to any person, firm, corporation, or business located anywhere in the world, regardless of whether that person, firm, corporation, or business is engaged in direct or indirect competition with Purchaser.

2.5 DCC shall have no right to make, have made, use, or sell POLYTRAP(R) materials, or license any third party to do so, for use in the Field, for the term specified in Section 2.3.

2.6 DCC has carefully read and considered the provisions of this Section 2, and having done so, agrees that the agreements and restrictions set forth in this Section, including without limitation, the time period of restriction and the geographical area of restriction, are bargained for, and are fair and reasonable restrictions on DCC.

### SECTION 3. New POLYTRAP(R) Developments

3.1 If, during the term of this Non-Compete Agreement, DCC acquires licensable or sublicensable patent rights in POLYTRAP(R), uses of POLYTRAP(R), or methods of making POLYTRAP(R), discovered after the date of this Non-Compete Agreement, DCC agrees not to license or sublicense those rights to any third party, without first offering such license or sublicense on the same terms to Purchaser. Any license granted by DCC pursuant to this Section shall be, subject to the extent of rights obtained by DCC, exclusive in nature for the term of this Non-Compete Agreement and nonexclusive thereafter. Any such license shall not bear a royalty in excess of five percent (5%) of the net sale price of POLYTRAP(R) discovered after the date of this Non-Compete Agreement and covered by such patent.

## SECTION 4. Fee.

4.1 In consideration of the agreements of DCC contained in this Non-Compete Agreement, Purchaser agrees to pay to DCC the agreed upon consideration set forth in Paragraph 3.1 in the Asset Purchase Agreement, the consideration of which compensates DCC for obligations undertaken in this Non-Compete Agreement.

## SECTION 5. Notices.

5.1 All demands, notices, and communications hereunder shall be in writing, and shall be given by United States mail (certified, return receipt requested), overnight courier services, or other means, in each case with all postage or delivery charges prepaid, to the party entitled thereto at such party's address as set forth below:

If to DCC:                               Dow Corning Corporation  
2200 West Salzburg Road  
Midland, MI 48686-0994  
Attention: General Counsel

If to Purchaser:                       Advanced Polymer Systems, Inc.  
3696 Haven Avenue  
Redwood City, CA 94063

or at such other address as such party may hereafter furnish to the other party, by notice conforming to the requirements of this Section. Any demand, notice, or communication hereunder shall be deemed to have been received by the appropriate party three (3) business days after being so mailed.

**SECTION 6. Separability Clause.**

Any provision of this Non-Compete Agreement that conflicts with applicable law, or is held to be void or unenforceable, shall be ineffective to the extent of such conflict, voidness, or unenforceability, without invalidating the remaining provisions hereof, which remaining provisions shall be enforceable to the fullest extent permitted under applicable law.

**SECTION 7. Governing Law.**

This Non-Compete Agreement shall be construed, and the obligations, rights and remedies of the parties hereunder shall be determined, in accordance with the laws of the State of Michigan, without reference to the principles of conflict of laws thereof.

**SECTION 8. Successors and Assigns; Assignment of Agreement.**

This Non-Compete Agreement shall bind and inure to the benefit of, and be enforceable by the parties hereto, and their respective successors and assigns. This Non-Compete Agreement may not be assigned, pledged, or hypothecated by any party hereto, to any person not a party hereto, whether by operation of law or otherwise, without the consent of all parties to this Non-Compete Agreement. This Non-Compete Agreement is not intended to confer upon any person not a party hereto any rights or remedies hereunder, unless such person is a permitted successor to or an assignee of a party hereto.

## SECTION 9. Waiver.

The failure of any party to insist upon strict performance of any covenant or obligation hereunder, irrespective of the length of time for which such failure continues, shall not be deemed a waiver of such party's right to demand strict performance of such covenant or obligation at a later time. No consent to or waiver of any breach or default in the performance of any covenant or obligation hereunder, whether express or implied, shall constitute a consent to or waiver of any other breach or default in the performance of the same, of any other covenant or obligation hereunder. No term or provision of this Non-Compete Agreement shall be deemed waived unless such waiver is in writing, and signed by the party against whom such waiver is sought to be enforced.

## SECTION 10. Term of Non-Compete Agreement.

This Non-Compete Agreement shall remain in effect from its date of execution until December 31, 2005, unless terminated sooner as provided in Section 2.2.

## SECTION 11. Entire Agreement.

This Non-Compete Agreement constitutes the entire agreement, and supersedes all other prior agreements and understandings, both written and oral, between the parties hereto, with respect to the transactions contemplated hereby, and the subject matter hereof. No provision of this Non-Compete Agreement may be modified, altered, or amended except in writing executed by all parties hereto.

SECTION 12. Captions.

The Section and other headings contained in this Non-Compete Agreement are inserted only as a matter of convenience and for reference, and in no way define, limit, extend, or describe the scope of this Non-Compete Agreement, or the intent of any provision hereof.

SECTION 13. Counterparts.

This Non-Compete Agreement may be executed simultaneously in any number of counterparts, each of which shall be deemed to be an original, and all of which shall constitute but one and the same instrument.

SECTION 14. Enforceability,

In the event of default by Purchaser thirty (30) days after receipt by Purchaser of notice of such default from DCC, of consideration due DCC under the terms of the Asset Purchase Agreement, then this Non-Compete Agreement shall be null and void, and unenforceable against DCC.

IN WITNESS WHEREOF, the parties hereto have caused this Non-Compete Agreement to be executed by their respective officers thereunto, duly authorized.

ADVANCED POLYMER SYSTEMS, INC.

DOW CORNING CORPORATION

By: \_\_\_\_\_

By: \_\_\_\_\_

Leon D. Crossman  
Vice President & Director,  
Science & Technology

Date: \_\_\_\_\_

Date: \_\_\_\_\_

YEAR	
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	JAN-01-1995
	DEC-31-1995
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	0
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	13,978,524
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	11,047,399
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	445,501
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(9,358,530)	0
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	(9,358,530)
	(0.57)
	(0.57)